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UNITED STATES TAX COURT

FRANK CEDRONE AND LENORA CEDRONE, Petitioners,
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 3203-78. Filed March 5, 1986.

Held: Amounts owed to petitioners and deposited in accounts held by petitioners, or paid in satisfaction of petitioners' personal obligations or the obligations of their wholly owned corporations, constitute income to petitioners. Held further, petitioners are entitled to a section 166(d) nonbusiness bad debt deduction for the payment of a wholly owned corporation's obligations. Held further, petitioners are entitled to a section 165 loss deduction on the sale of property held for use in their trade or business. Held further, petitioners are liable for additions to tax pursuant to section 6653(b).

Frank Cedrone and Lenora Cedrone, pro se.

George W. Connelly, Jr., for the respondent.

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MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: Respondent determined deficiencies in, and additions to, petitioners' Federal income tax for the years and in the amounts indicated:

Petitioner	Year	Deficiency	Addition to Tax Section 6653(b)[1]
Frank Cedrone	1970	$ 4,622.79	$ 2,311.39
Frank Cedrone & Lenora Cedrone	1971	221,730.81	110,865.41
	1972	15,913.48	7,956.74

The issues presented for decision are:

(1) Whether petitioners received unreported income in each of the years at issue;

(2) whether petitioners are entitled to a deduction for:

(a) payments made as guarantors of a wholly owned corporation's debts;

(b) losses incurred on the sale of a wholly owned corporation's plants, trucks, and trailers;

(c) losses incurred on the sale of property held by petitioners for use in their trade or business; and

(d) restitution payments made to the Town of Fleming in 1976;

(3) whether Lenora Cedrone is entitled to relief from liability pursuant to the section 6013(e) innocent spouse provisions;

(4) whether petitioners are liable for additions to tax pursuant to the section 6653(b) civil fraud addition.

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

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FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners Frank Cedrone (Cedrone) and Lenora Cedrone (Mrs. Cedrone), husband and wife, were married at all times relevant to this case. They resided in Fulton, New York, at the time they filed their petition herein. Petitioners are the parents of two sons, Frank Cedrone, Jr. and Peter John Cedrone, who were petitioners' dependents during the years at issue.

This case is based upon two statutory notices of deficiency. The first notice was issued to Cedrone and relates to the taxable year 1970. Petitioners filed separate returns for 1970, and Mrs. Cedrone's return is not at issue. The second notice was issued to petitioners and relates to the taxable years 1971 and 1972, in which they filed joint returns.

Cedrone was engaged in the construction business in New York from approximately 1951 through the years in issue. He pursued this business as president and owner or sole shareholder of a number of unincorporated companies or incorporated entities, the following of which are relevant to the issues before us:

(1) Chesterlyn Pipe Line Co., Inc. (Chesterlyn). Chesterlyn was experiencing financial difficulties during the years at issue, and was liable for numerous liens and judgments;

(2) Quality Redi-Mix Co., Inc. (Quality Mix);

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(3) Bar-Lum Soil Systems, Inc. (Bar-Lum);

(4) Quality Pipe Line Co. (Quality Pipe).

Mrs. Cedrone graduated from high school and attended 1 year of business school. After graduation, she went to work for her father's business, Massaro Company, Incorporated (Massaro). Her father died in 1963, at which time responsibility for the operation of Massaro devolved upon Mrs. Cedrone, her sisters, and her brother. Mrs. Cedrone continued to work for Massaro until the business went bankrupt in 1969.

In February 1969, a resolution was passed to create a sewer district in the Town of Fleming, County of Cayuga, New York. The project was estimated to cost $2,500,000. Bids were first let in June 1970, at which time the lowest bid received was $2,700,000; all bids were rejected as excessive. Due to liens filed against Chesterlyn and his other businesses, Cedrone was unable to participate in the June 1970 bidding.

Revised bids were to be opened in October 1970. Between the June and October bids, Cedrone was encouraged by Vito M. Pastore (Pastore) and Louis Contiguila (Contiguila) to enter a bid on the Town of Fleming Sewer Project (Sewer Project). At that time, Pastore was the legal representative for the Town of Fleming. Cedrone estimated that the work could be done for roughly $1,500,000.

Kenneth C. Marshall (Marshall) owned and operated J&K Pipe Co. (J&K). After discussions between Cedrone and Marshall, it was agreed that J&K would submit a bid pursuant to Cedrone's

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estimate. Additionally, Cedrone and Marshall agreed that if J&K was awarded the project, Cedrone would serve as project manager and would be paid 10 percent of the gross contract price plus $400 per week. The 10-percent commission constituted a bonus for Cedrone's services as project manager and rent for J&K's use of Quality Mix's construction equipment.

J&K's October 1970 bid of $1,532,069 was the lowest received. The J&K bid was defective, however, because it did not include a bid bond. The Fleming Town Board agreed to accept the bid if a performance bond could be obtained. Pastore subsequently advised the Fleming Town Board that the performance bond requirements had been satisfied, and the project was awarded to J&K on October 26, 1970. On that date, an Agreement for Construction of Sanitary Sewers was entered into between Marshall d/b/a J&K and the Town of Fleming in the amount of $1,532,069. Marshall formed and incorporated Ron-Ore Soil Systems, Ltd. (Ron-Ore) in New York State on December 3, 1970. The name Ron-Ore was derived from the names Cedrone and Pastore. Upon its formation, Ron-Ore assumed J&K's contract with the Town of Fleming.

Cedrone served as project manager for J&K and Ron-Ore for the duration of the Sewer Project. Additionally, during June or July 1971, Cedrone assumed the position of president of Ron-Ore, and remained in that position throughout Ron-Ore's work on the project. Neither petitioner was ever a shareholder in Ron-Ore.

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Beginning in July 1971, a disbursement journal (check listing) was maintained for Ron-Ore by Mrs. Cedrone or her sister, Carrie Orlando. Additionally, during the period November 1970 through October 1972, Mrs. Cedrone prepared the weekly payroll ledgers for Ron-Ore, cards for each of the employees, and quarterly payroll tax returns. She had been unemployed since the bankruptcy of Massaro. On the advice of her doctor, she sought limited employment as therapy for her depression resulting from the bankruptcy of Massaro and attendant family disagreements. Mrs. Cedrone accepted Marshall's offer of employment on the condition that she be allowed to work at home. Her two sons were living at home, and she did not want to commute from Fulton to Fleming, a distance of approximately 40 miles.

During the taxable years 1970, 1971, and 1972, the Town of Fleming paid Ron-Ore or certain specified parties $150,159.60, $1,356,514.63, and $134,292.60, respectively, pursuant to the Sewer Project contract. Between November 10, 1970, the date of the first check, and January 28, 1972, the checks were made payable to J&K, although they were deposited in Ron-Ore's bank accounts. Ron-Ore maintained three bank accounts during the years at issue. Two of the accounts were with the Marine Midland Bank of Central New York: Account Number 290-78321-6 (Marine Account I) was in the name of Ron-Ore care of Cedrone and only Cedrone was authorized to sign checks on this account; Account Number 290-78102-7 (Marine Account II) was in Ron-Ore's name and

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only Marshall and "George Sedrick"[2] were authorized to sign checks on this account.[3] Ron-Ore had a third account with the First National Bank of Waterloo (Waterloo account) and only Cedrone was authorized to sign checks on this account.

Ron-Ore did not file corporate tax returns for the years 1970, 1971, or 1972. Additionally, formal corporate records of Ron-Ore for the period December 1970 through June 1971, and from April 1972 through December 1972, do not exist. Whatever records Ron-Ore did maintain during 1971 and 1972 were turned over to New York State for its criminal investigation of the Sewer Project. Quality Mix also failed to file corporate tax returns for the years at issue.

Petitioners opened or maintained at least 10 checking or savings accounts during the years at issue. These accounts were either in petitioners' names, or were held in trust by them for their sons. A large number of checks were drawn upon one of the three Ron-Ore accounts and were deposited in one or more of the accounts maintained by petitioners. A number of the checks run from Ron-Ore to companies owned by Cedrone, or to creditors of

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2 "George Sedrick" was a fictitious person; a stamp bearing the signature of "George Sedrick" was used to "sign" Ron-Ore checks on this account.

3 In respondent's brief, Ron-Ore's Marine Midland Bank account number 290-78102-7 is referred to as "Marine Account I" and account number 290-78321-6 is referred to as "Marine Account II." For purposes of convenience, we have reversed these designations throughout this opinion.

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companies owned by Cedrone. Additionally, numerous checks were payable to fictitious payees. A chronological synopsis of these transactions as stipulated to by the parties is set forth below.

Specific Transactions - 1970

The following checks were drawn on Ron-Ore's Marine Account II.

Check Number	Amount	Payee	Application of Funds
107	$4,000.00	Cedrone	Deposited in a savings account held in Cedrone's name.
243	$3,500.00	Cedrone	Deposited in a savings account held in Cedrone's name.
244	$3,500.00	Cedrone	Deposited in a savings account held in Cedrone's name.
242	$3,500.00	James Rello	A fictitious payee.

In addition to the specific transactions listed above, checks totaling $11,660.01 were drawn on the account of Quality Mix and were applied in whole or in part for petitioners' benefit.

Specific Transactions - 1971

The following checks were drawn on Ron-Ore's Marine Account II:

Check Number	Amount	Payee	Application of Funds
411	$10,000.00	Williams Co.	A fictitious payee. $5,000 was given to Pastore. $5,000 was deposited by Mrs. Cedrone in a savings account held in Cedrone's name.
573	$ 600.00	Springer Cadillac	Used by Cedrone as a down payment on a Cadillac automobile.

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Check Number	Amount	Payee	Application of Funds
843	$ 9,055.44	Springer Cadillac	Used by Cedrone to pay the balance due on the Cadillac automobile.
796	$ 7,500.00	Quality Co.	Deposited in an account held in the name of "Frank Cedrone or Lenora Cedrone in trust of Peter Cedrone."
909	$26,991.00	Carrie Orlando	Used to pay purchase price, filing fees, and taxes on petitioners' house.
1009	$ 7,500.00	Frank & Lenora Cedrone & the Lincoln National Bank	Payment of principal and late charge on loan for dump truck and backhoe.
913	$10,000.00	Cedrone	Used to purchase two bank checks which were deposited in a savings account held in Cedrone's name.
1119	$10,000.00	Cedrone	Deposited in a savings account held in Cedrone's name.
1127	$ 1,200.00	Cedrone	Deposited in a savings account held in Cedrone's name.
1136	$ 500.00	Carmella Massaro	Carmella Massaro is Mrs. Cedrone's mother; the check was a gift to her.
1137	$17,601.79	Jefferson Lewis Savings and Loan	Used to satisfy an outstanding mortgage on real property owned by Mrs. Cedrone.
1181	$ 1,673.68	Cash	Deposited in an account held in the name of "Frank Cedrone or Lenora Cedrone in trust of Peter Cedrone."
1291	$10,000.00	Jack Carr	A fictitious payee. The check was endorsed by Cedrone and deposited in an account held in Cedrone's name.

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Check Number	Amount	Payee	Application of Funds
1326	$10,000.00	Cedrone	Deposited in an account held in Cedrone's name.
1349	$ 4,000.00	Jack Williams	A fictitious payee. The check was endorsed by Cedrone and deposited in an account held in Cedrone's name.
1350	$ 890.00	Fred Young	A fictitious payee. The check was endorsed by Cedrone and subsequently cashed by him.
1353	$ 1,000.00	Cedrone	Cashed by Cedrone.
1443	$32,500.00	Bar-Lum	Deposited in an account held in the name of Bar-Lum. This payment represents a portion of Cedrone's 10% commission on the Fulton sewer project.
1444	$28,000.00	Bar-Lum	Deposited in an account held in the name of Bar-Lum. This payment represents a portion of Cedrone's 10% commission on the Fulton sewer project.
1530	$ 4,281.24	Cash	Cashed by Cedrone.
1630	$ 683.68	Frank & Lenora Cedrone & Lincoln National Bank	Used to make payment on petitioners' loan from Lincoln National Bank.

The following checks were drawn on Ron-Ore's Marine Account I.

Check Number	Amount	Payee	Application of Funds
3	$ 2,500.00	Cedrone	Cashed by Cedrone.
6	$ 1,500.00	Cash	Cashed by Cedrone.
2011	$ 500.00	Cedrone	Cashed by Cedrone.
2021	$ 3,000.00	Leonard Cedrone	Applied in satisfaction of various debts outstanding against Chesterlyn.

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Check Number	Amount	Payee	Application of Funds
2060	$ 2,300.00	Leonard Cedrone	Applied in satisfaction of various debts outstanding against Chesterlyn.
2163	$ 1,540.00	Cedrone	Deposited in a savings account held in Cedrone's name.
2264	$ 3,600.00	Cedrone	Cashed by Cedrone after having been endorsed by both petitioners.
2290	$ 2,500.00	Cedrone	Deposited in a savings account held in Cedrone's name.
2292	$ 2,500.00	Cedrone	Deposited in a savings account held in Cedrone's name.
2388	$ 1,500.00	Cedrone	Deposited in a savings account held in the name of "Lenora in trust for Cedrone."
2396	$ 4,000.00	Cedrone	Applied in full settlement of a claim by Utica Mutual Insurance Company against Cedrone and Chesterlyn.
2071	$ 4,359.00	Angelo L. Cedrone	Applied in satisfaction of various debts outstanding against Chesterlyn.
2166	$ 508.00	Smith Bros.	$100.00 of this amount constituted income to petitioners.
2404	$ 840.64	Bergan Electric	$350.00 of this amount constituted income to petitioners.

The following checks were drawn on Ron-Ore's Marine Accounts I and II in the gross amounts indicated. The checks were payable to "payroll-cash" or "cash-payroll" and the proceeds were used to satisfy Ron-Ore's net payroll obligations. All checks were cashed by Mrs. Cedrone, with the exception of check number 2374, which was endorsed by Cedrone

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and a third person, and check number 2376 which was endorsed and cashed by Cedrone. Generally, Mrs. Cedrone would telephone Marshall to determine the number of hours worked by each employee during a pay period. Cedrone would then deliver to Mrs. Cedrone a presigned but otherwise blank check drawable upon a Ron-Ore account. Mrs. Cedrone would complete and cash the check, stuff the payroll envelopes, and deliver the gross amount in excess of net payroll obligations to Cedrone.

Payroll checks included amounts for both employee bonuses and job purchases. Ron-Ore's employees were paid a bonus of 10 cents per lineal foot of pipe laid. Job purchases included trowels, shovels, picks, cement, pails, boots, and raincoats needed for completion of the job. Additionally, payments were made to a union agent to ensure an adequate supply of labor.

Check Number	Gross Amount	Net Payroll	Gross Amount Included in Income[4]
2006	$6,305.31	$4,453.71	$2,378.61
2023	4,734.31	4,344.31	390.00
2066	6,018.37	5,107.72	1,113.40
2071	4,777.89	4,662.29	115.60
2084	5,890.08	4,390.08	1,500.00

[4] Checks numbered 2006, 2066, 2268, and 2300 were not issued for the entire net payroll then due, as some employees were paid by separate check. The apparent discrepancies between the gross amount of each check, the net payroll obligations for that week, and the excess cash is explained as follows:

	Check No. 2006	Check No. 2066	Check No. 2268	Check No. 2300
Gross amount of check	$6,305.31	$6,018.37	$5,570.80	$4,342.96
Net payroll per books	4,453.71	5,107.72	5,327.57	4,812.06
Difference	1,851.60	910.65	243.23	(469.10)
Payroll by other check	527.01	202.75	256.77	1,562.50
Gross amount in excess of net payroll	$2,378.61	$1,113.40	$ 500.00	$1,093.40

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Check Number	Gross Amount	Net Payroll	Gross Amount Included in Income
2112	4,944.40	4,298.10	646.30
2132	5,739.18	5,539.18	200.00
2150	5,182.86	4,982.86	200.00
2161	5,692.85	5,492.85	200.00
2186	8,837.73	5,012.73	3,825.00
2214	6,201.26	5,401.26	800.00
2231	7,075.16	6,775.16	300.00
2247	6,964.26	5,551.88	1,412.38
2268	5,570.80	5,327.57	500.00
2300	4,342.96	4,812.06	1,093.40
2311	3,671.70	3,171.70	500.00
2317	3,833.34	3,533.34	300.00
2342	3,928.93	3,628.93	300.00
2374	6,500.00	3,463.53	3,036.47
2376	4,714.69	3,897.39	817.30

For the year 1971, the disbursement journal indicates that some or all of the gross amount in excess of net payroll obligations for the following payroll checks were used for employee bonuses or job purchases.

1971

Check Number	Application of Funds	Amount
2006	Employee Bonus	$2,293.25
2023	Job Purchases	390.00
2066	Job Purchases	1,013.00
2071	Job Purchases	100.00
2084	Job Purchases	1,500.00
2112	Job Purchases	500.00
2132	Job Purchases	200.00
2161	Job Purchases	200.00
2186	Employee Bonus	3,425.00
2214	Job Purchases	800.00
2231	Job Purchases	300.00
2247	Job Purchases	1,412.38[5]

[5] The disbursement journal indicates that $1,600 of check number 2247 was allocated to job purchases. We limit the adjustment here to the amount of check number 2247 which respondent included in petitioners' income.

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Check Number	Application of Funds	Amount
2300	Job Purchases	1,000.00
2311	Job Purchases	500.00
2342	Job Purchases	300.00
2374	Job Purchases	3,036.47
2376	Job Purchases	800.00
		$17,770.10

Specific Transactions - 1972

The following checks were drawn on Ron-Ore's Marine Account I:

Check Number	Amount	Payee	Application of Funds
2460	$ 500.00	Cedrone	Deposited in a savings account held in Cedrone's name.
2461	$ 500.00	Cedrone	Deposited in a savings account held in Cedrone's name.
2503	$1,300.00	Cash	Endorsed by Mrs. Cedrone; used to purchase $800 in travelers checks and pay an $8 service fee. The balance was taken in cash.
2506	$3,959.80	Spector Genesee Motor Sales, Inc.	Used as a down payment on a Cadillac automobile purchased by Cedrone in the name of Bar-Lum.
2514	$4,000.00	Cash	Endorsed and negotiated by Cedrone for teller's checks and cash. Teller's checks used to pay for appliances, heating, plumbing, and assorted improvements to petitioners' home.

The following checks were drawn on Ron-Ore's Waterloo Account:

Check Number	Amount	Payee	Application of Funds
112	$ 560.83	DeSpirtito Lumber and Mason Supplies, Inc.	Used to purchase stone, slate, and other materials for petitioners' residence.

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Check Number	Amount	Payee	Application of Funds
124	$ 137.50	Frank E. Black Nursery	Used to pay for gardening work performed at petitioners' residence.
133	$1,156.94	Armour Alarm Systems	Used to pay for an electrical protection system and one year's service thereon at petitioners' residence.
139	$ 637.00	Thermasol Ltd.	Used to purchase a steam generator for petitioners' residence.
146	$2,254.60	Cash	Used to pay for petitioners' home improvements.
174	$ 110.40	Fulton Builders Supply Co., Inc.	Used to pay for petitioners' home improvements.
203	$ 607.32	Cash	Deposited in a savings account held in the name of "Mrs. Cedrone in trust for Cedrone."
209	$ 197.94	Bailey Electric Service	Used to pay for the installation of fixtures and wiring at petitioners' residence.
212	$ 101.65	John LaManna & Son	Used to pay for flowers at the funeral of Cedrone's brother.
213	$ 90.95	Anthony's Flower Shop	Used to pay for flowers at the funeral of Cedrone's brother.
225	$ 123.91	McDonald's Wall-paper & Paint	Used to purchase wallpaper and other materials for petitioners' residence.
217	$ 493.10	DeSpirito Lumber, Inc.	Used to purchase miscellaneous building materials.
232	$ 308.36	Erie House of Kitchens, Inc.	Used as partial payment on various items for petitioners' residence.
196	$ 404.37	Fulton Builders Supply, Inc.	Used to purchase panelling and materials for petitioners' residence.

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Check Number	Amount	Payee	Application of Funds
182	$ 245.67	Bailey Electric Service	Used to purchase lighting fixtures and other materials for petitioners' residence.
200	$1,673.00	Perro & Sons, Inc.	Used to satisfy part of the cost of the funeral of Cedrone's brother.
173	$2,000.00	Elmer Shaw & Co.	Used to pay accounting services for Chesterlyn.
233	$1,490.46	Ramsey G. Ludington	Used to pay for legal services for Chesterlyn.

The following checks were drawn on Ron-Ore's Marine Account I or Waterloo account in the gross amounts indicated. The checks were payable to "cash-payroll" and the proceeds were used to satisfy Ron-Ore's net payroll obligations. Mrs. Cedrone endorsed and cashed all checks other than checks numbered 137, 152, 2501, and those endorsed by Cedrone. Cedrone endorsed checks numbered 2459, 2463, and 2471, which were then cashed by a third party. The procedure for cashing the payroll check and disbursing the funds was generally the same as that described for 1971.

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Check Number	Gross Amounts	Net Payroll	Gross Amount Included in Income[6]
2459	$1,931.50	$1,631.50	$ 300.00
2463	1,598.40	1,298.40	300.00
2471	1,655.35	1,264.83	408.52
2501	960.40	1,814.52	(707.82)
135	1,300.53	1,100.35	200.00
137	1,303.58	1,103.58	200.00
141	1,619.79	1,119.79	500.00
145	1,281.26	1,001.26	280.00
151	915.78	715.78	200.00
152	1,526.27	826.27	700.00
154	905.98	605.98	300.00
155	689.42	489.42	200.00
161	1,374.75	1,024.75	350.00
162	1,364.49	1,018.57	314.00
			$3,544.70

For the year 1972, the disbursement journal indicates that some or all of the gross amount in excess of net payroll obligations for the following payroll checks were used for job purchases.

Check Number	1972 Application of Funds	Amount
2459	Job Purchases	$ 300.00
2463	Job Purchases	300.00
2471	Job Purchases	408.52[7]
		$1,008.52

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6 Check Number 2501 was not written for the entire net payroll then due, and one employee was paid by check. The apparent discrepancy can be explained as follows:

Net Payroll per books	$1,814.52
Gross check	(960.40)
Check to Employee	(146.30)
Difference - deemed contributed by petitioners	$ 707.82

7 The disbursement journal indicates that $500 of check number 2471 was allocated to job purchases. We limit the adjustment here to the amount of check number 2471 which respondent included in petitioners' income.

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Rental Income - 1971 and 1972

Prior to her father's death, Mrs. Cedrone acquired an interest in two pieces of real property. The first piece of property was a building in Chaumont, New York, leased by the United States as a post office. Mrs. Cedrone and her father undertook the building's construction in 1961-1962. Her father bequeathed his interest in the post office to her at his death. During 1971 and 1972, rents totaling $2,768.02 and $2,715.57, respectively, were paid to Mrs. Cedrone with respect to this facility. Neither income, nor expense or depreciation deductions, associated with this property were reported by petitioners during 1971 or 1972. The outstanding mortgage on the building was called by the Jefferson Lewis Savings Bank in 1971. Cedrone wrote a check for $17,601.79 in satisfaction of this obligation.

The second piece of property was a house built for Mrs. Cedrone by her father, title to which remained in his name at the time of his death. As a result of acrimonious relations between Mrs. Cedrone and her brother, Mrs. Cedrone was forced to pay $26,991 to acquire title to the property. A check in this amount was written by Cedrone to Carrie Orlando, Mrs. Cedrone's sister, in 1971.

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Various Payments, Judgments, and Sales

Between 1969 and 1973, numerous judgments were filed against Chesterlyn, and against petitioners as owners thereof. During 1971, Ron-Ore made payments in the amounts indicated below in satisfaction of these judgments.

Payee/Recipient	Amount
Equipment Finance Co.	$3,000.00
Johns-Manville	2,300.00
Utica Mutual Insurance	4,000.00

Cedrone posted a performance bond with Utica Mutual Insurance Company (Utica) as guarantor of a construction job undertaken by Chesterlyn. The performance bond was in the form of a $15,000 certificate of deposit issued by Merchants National Bank and Trust Company. Chesterlyn defaulted on its obligations, and in 1970, Utica foreclosed on the performance bond in partial satisfaction of Chesterlyn's debts.

Additionally, improved real property owned by Cedrone and located in the Town of Scriba, New York, was levied upon by the Sheriff of Oswego County to satisfy a judgment obtained against Cedrone by Johns-Manville Sales Corporation relative to obligations of Chesterlyn. This property was sold at public auction during February 1970 for $4,950. The property sold included 25 acres of land purchased by Cedrone for $1,000, and held in his name. Cedrone improved the land with 8 to 10 feet of gravel landfill covering an area approximately 300 feet long

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and 150 feet wide. Cedrone estimated that he used 10,000 to 15,000 cubic yards of gravel at a cost of approximately 80 cents a yard. A building was placed on the landfill at a cost of approximately $17,000, and a well and heating system cost an additional $6,000. The building was used by Cedrone to store construction equipment.

Quality Mix purchased a Redi-Mix plant from H.L. Baughman in 1969. It paid $5,000 for the plant, which was located in Buffalo, New York, and an additional $10,000 to relocate the plant to property rented from New York Central Railroad in Fulton, New York. The plant was sold by Quality Mix to Rizzo Construction Company (Rizzo) in the fall of 1970 for $15,000. Included in the sale were several Redi-Mix trucks and a trailer purchased by Quality Mix subsequent to its acquisition of the plant.

Legal Proceedings

The Town of Fleming instituted suit against Cedrone, Ron-Ore, and others relative to their participation in the Sewer Project. This lawsuit was settled during 1976, and the terms of settlement included the payment by Cedrone of restitution in the amount of $150,000.

On May 8, 1974, a Federal Grand Jury for the Northern District of New York returned a five-count indictment against petitioners. At their arraignment, both petitioners entered pleas of not guilty to all charges. On September 15, 1975, Cedrone entered a plea of guilty to Count II of that

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indictment, which charged a violation of section 7201 for 1972, and he was thereupon convicted of that charge. The remaining counts against petitioners were dismissed.

OPINION

We must initially determine whether petitioners received unreported income for each of the years at issue, and if so, in what amount. Respondent asserts that petitioners failed to report as income amounts withdrawn from Ron-Ore and Quality Mix which directly or indirectly accrued to petitioners' benefit.

Respondent's determination of a deficiency is presumptively correct, and petitioners bear the burden of proof in demonstrating otherwise. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). It is a settled rule of law that where a taxpayer's records are inadequate, unreliable, or nonexistent, respondent may reconstruct income using any method which will, in respondent's opinion, clearly reflect income. Section 446(b); Holland v. United States, 348 U.S. 121 (1954); Webb v. Commissioner, 394 F.2d 366 (5th Cir. 1968), affg. a Memorandum Opinion of this Court. Harper v. Commissioner, 54 T.C. 1121 (1970). The only restriction on this rule is that the method adopted must be reasonable. Stone v. Commissioner, 22 T.C. 893, 905 (1954).

Respondent contends that funds withdrawn by Cedrone from Ron-Ore and deposited in accounts controlled by him represent service income to Cedrone as president of Ron-Ore and manager of the Sewer Project.

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Cedrone contends that these amounts represent rental income owed to Quality Mix by Ron-Ore for the use of construction equipment. Cedrone asserts that the payments were deposited in his accounts to allow for the orderly payment of his creditors and the creditors of his wholly owned businesses.

We have found that Cedrone agreed with Marshall to serve as manager of the Sewer Project and to rent Quality Mix equipment to Ron-Ore for a commission equal to 10 percent of the gross contract price. No evidence was submitted as to the type or fair rental value of Quality Mix equipment used by Ron-Ore in the sewer project. Neither Quality Mix nor Ron-Ore filed corporate income tax returns for the years at issue, and no evidence has been submitted as to the amount paid by Ron-Ore to Quality Mix for the use of the equipment. Petitioners concede that the funds were withdrawn by them and were deposited in accounts under their control. No attempt was made to segregate funds purportedly belonging to Quality Mix from petitioners' personal assets. We are convinced that no such distinction existed.

As owner and president of Quality Mix, and manager and president of Ron-Ore, Cedrone had sole discretion over the allocation of the commission between personal income to him and rental income to Quality Mix. We decline Cedrone's invitation to restructure transactions over which he had complete control. Therefore, we find that respondent's allocation of amounts

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withdrawn from Ron-Ore and deposited in accounts held in Cedrone's name is reasonable, and that such amounts should be included in petitioners' income for the years at issue.

Respondent next asserts that Ron-Ore's payment of petitioners' personal bills constitutes income to petitioners, and we agree. The payment of personal debts as compensation for services rendered constitutes income under the most basic tenets of our taxing system. Section 61(a)(1). See Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929). It is of no significance that payment was made directly to petitioners' creditors rather than first coming under petitioners' control. We find that all checks drawn on Ron-Ore's account in payment of petitioners' personal debts constitute income to petitioners in the year paid.

Respondent has determined that the gross amount of various payroll checks drawn on Ron-Ore's Marine Account I and Waterloo Account in excess of net payroll obligations represents income to petitioners in 1971 and 1972. Petitioners contend that the gross amount in excess of net payroll obligations was used to pay for employee bonuses and job purchases related to the Sewer Project. During this period, a disbursement journal was maintained for Ron-Ore by Mrs. Cedrone and her sister. This journal indicates the payee, amount, and application of certain funds withdrawn from Ron-Ore accounts. In substantiation of

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Cedrone's testimony, the journal indicates that $18,878.62 of the gross amount in excess of net payroll obligations was spent on employee bonuses or job purchases.

We accept petitioners' explanation of employee bonuses and job purchases. Any construction job the size of the Sewer Project is going to involve unexpected cash expenditures. We hold that petitioners' unreported income for the years 1971 and 1972 should be reduced by $17,770.10 and $1,008.52, respectively, in accordance with the employee bonuses and job purchases recorded in the disbursement journal as indicated in the statement of facts. As to the remainder of these adjustments, petitioners have failed to carry their burden of proof.

With the exception of check number 855, which respondent has conceded constitutes a business expense of Ron-Ore and is not includable in petitioners' income, we sustain respondent's finding as to the remaining miscellaneous withdrawals from Ron-Ore and Quality Mix.

Excluding the payroll checks, petitioners have wholly failed to meet their burden of proof in demonstrating error in respondent's determinations. Respondent, on the other hand, has constructed a detailed record tracing the withdrawal of funds from Ron-Ore to petitioners, their creditors, or the creditors of their businesses. Although respondent's determination of gross income may not be precise, in a record involving hundreds of checks and more than a dozen bank accounts, no greater precision can be asked for. The approximation of income by

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respondent is not arbitrary where facts sufficient to support the approximation are shown. Estate of Nitto v. Commissioner, 13 T.C. 858, 866 (1949). What uncertainty remains is clearly of petitioners' own making. Petitioner has not disputed respondent's determination of unreported dividends, interest, and rental payments for the years at issue; we find that these also constitute income to petitioners.

Having sustained respondent's determination of petitioners' gross income, as modified above, we must next determine the appropriateness of certain deductions claimed by petitioners.

Cedrone contends that his payment of $56,285.82 in debts owed by Chesterlyn during 1971 and 1972 entitle him to a "loss" deduction for the year in which the debts were paid. We have found that some of the debts were paid with checks which were drawn on Ron-Ore's account and included in Cedrone's income. Additionally, Cedrone claims a loss of $15,000 for 1970 based on Utica's foreclosure on a certificate of deposit which he pledged as guarantor of a Chesterlyn debt.

Respondent allowed a nonbusiness bad debt of $1,000 for the years 1971 and 1972 pursuant to section 166(d). Respondent concedes that Cedrone's payment of Chesterlyn debts may qualify as nonbusiness bad debts, but asserts that they will not impact on petitioners' deficiency for the years at issue because of the section 1211 loss limitations.

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It is a well settled rule that shareholders are not entitled to pay and claim a deduction for corporate expenditures. Rink v. Commissioner, 51 T.C. 746, 752 (1969); Koree v. Commissioner, 40 T.C. 961, 965-966 (1963); Kahn v. Commissioner, 26 T.C. 273 (1956). Cedrone's expenditures were not those of his own trade or business, but rather were those of Chesterlyn. This is true even when the shareholder owns all or a majority of the corporation's stock and is in complete control of the corporation's affairs. Deputy v. du Pont, 308 U.S. 488 (1940); Burnet v. Clark, 287 U.S. 410 (1932); Rink v. Commissioner, supra at 750-752. Where payments are made to protect or enhance the value of a person's stock in the corporation, such payments are generally treated as capital contributions. Koree v. Commissioner, supra at 966.

Section 166(a) provides that a deduction shall be allowed for any debt which becomes wholly worthless during the taxable year. Section 166(d), however, provides that, in the case of a taxpayer other than a corporation, a loss attributable to the worthlessness of a nonbusiness bad debt shall be treated as a short-term capital loss. Pursuant to section 166(d)(2), a nonbusiness debt is defined as follows:

> (2) Nonbusiness debt defined.--For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than--
>
> (A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

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> (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

To be treated as a business debt, the debt must be proximately related to the taxpayer's trade or business. Sec. 1.166-5(b), Income Tax Regs.; Whipple v. Commissioner, 373 U.S. 193 (1963). Whether a debt is a nonbusiness or business debt is a question of fact. Sec. 1.166-5(b), Income Tax Regs.

Petitioners have provided no evidence in support of their claim that Chesterlyn's debts were created in connection with petitioners' business as a contractor. We cannot speculate as to what role Chesterlyn played in supplying pipe for the Sewer Project. Therefore, petitioners have again failed to meet their burden of proof. Welch v. Helvering, supra. On the record before us, we hold that petitioners' payment of Chesterlyn's debts does not bear a proximate relationship to petitioners' trade or business. Therefore, such payments (including the certificate of deposit) constitute nonbusiness bad debts pursuant to section 166(d)(2), entitling petitioners to a short-term capital loss as limited by section 1211[8] for the years 1970, 1971, and 1972.

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[8] We do not have the facts before us to determine whether some portion of Cedrone's payments in excess of the nonbusiness bad debts allowed in the years at issue constitute capital contributions to his wholly owned corporations. No single criterion nor any series of criteria can provide a conclusive answer to whether advances are loans or capital contributions. See John Kelley Co. v. Commissioner, 326 U.S. 521, 530 (1946). Factors which are of particular significance in making this determination include the capitalization of the corporation, use of the funds advanced, potential sources of repayment and the

(footnote continued)

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Petitioners claim a loss deduction of $10,000 incurred by Quality Mix on the sale of its cement plant. Petitioners have failed to establish that Quality Mix had a basis in the plant, trucks, and trailers in excess of the $15,000 realized on its sale. Additionally, the property sold belonged to Quality Mix, not petitioners, and any loss should be deducted by Quality Mix. Therefore, we deny this deduction to petitioners.

Petitioners claim a loss for the years at issue based upon their payment of $150,000 in restitution to the Town of Fleming in 1976. Respondent has denied this loss because it was not incurred during the years at issue. We hold for respondent. Petitioners are precluded from claiming the restitution as a loss during the years at issue because of the annual accounting concept on which the Federal income tax system is premised. See Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931); Fox v. Commissioner, 61 T.C. 704 (1974).

Cedrone contends that he suffered a loss of $25,050 in 1970 on the foreclosure sale of improved property located in the Town of Scriba, New York. Respondent agrees that the sale resulted in a loss.

(footnote continued from previous page)

concomitant risk of nonpayment, and comparability with loans by independent creditors. Gilboy v. Commissioner, T.C. Memo. 1978-114. If such payments do constitute capital contributions, then Cedrone may be entitled to additional losses in the year that his stock in such corporations becomes worthless. See sec. 165(g).

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It is well established that we may approximate a deduction where the taxpayer, through inadequate records, has failed to prove the precise amount of such deduction. Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). In this instance, the record establishes facts sufficient to make an approximation. Humes v. United States, 276 U.S. 487 (1928). The necessity for making an approximation is a result of petitioners' chronic failure to maintain business records. For this reason, any uncertainty as to the costs of a particular improvement has been decided in respondent's favor. Cohan v. Commissioner, supra. Thus, we determine petitioner's basis in the land and building to be as follows:

Land	$ 1,000
Landfill	4,000
Building	17,000
Well & heating System	6,000
	$28,000

The building was used by Cedrone to store construction equipment. It was sold for $4,950. Consequently, we find that Cedrone is entitled to an ordinary loss of $23,050 for the year 1970. This loss equals Cedrone's basis in the property in excess of his amount realized on the foreclosure sale.[9]

---

[9] Basis of $28,000 minus sale proceeds of $4,950 equals $23,050. As discussed above, Cedrone is entitled to a section 166(d) nonbusiness bad debt loss for his payments as guarantor of Chesterlyn's debts. While Cedrone testified that "something like $3,000 or $4,000 worth" of pipe had been purchased from Johns-Manville, there is no evidence as to how much of the $4,950 realized on the sale was used to satisfy Chesterlyn's debts. Thus, we can make no determination as to the amount of Cedrone's 1970 nonbusiness bad debt loss resulting from his obligation as guarantor thereof.

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Having sustained respondent's finding of a deficiency, as modified herein, we must next decide whether Mrs. Cedrone is an innocent spouse under section 6013(e),[10] which provides that, in certain circumstances, a spouse who has filed a joint Federal income tax return will be relieved from liability to the extent that such liability results from a substantial understatement of tax attributable to grossly erroneous items of one spouse. Petitioner has the burden of proving that all requirements for relief from tax as an innocent spouse are satisfied. Rule 142(a); Ratana v. Commissioner, 662 F.2d 220, 224 (4th Cir. 1981); Sonnenborn v. Commissioner, 57 T.C. 373, 380-381 (1971).

In order for petitioner to qualify for the relief provided by the statute, the following conditions specified in section 6013(e) must be satisfied:

> (e) Spouse Relieved of Liability in Certain Cases.--
>
> (1) In General.--Under regulations prescribed by the Secretary, if
>
> (A) a joint return has been made under this section for a taxable year,
>
> (B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,
>
> (C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and

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[10] Sec. 6013(e) was amended by the Tax Reform Act of 1984, Pub. L. 98-369, sec. 424(a), 98 Stat. 801, with retroactive application to all taxable years to which the Internal Revenue Codes of 1954 and of 1939 apply. See H. Rept. 98-432, (Pt. 2) 1501, 1503 (1984).

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> (D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement,
>
> then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.

The preliminary prerequisite for relief under section 6013(e)(1)(A) is that petitioners filed joint tax returns for the taxable years 1971 and 1972. This requirement has been satisfied. The second requirement is that there be a substantial understatement of tax attributable to grossly erroneous items of one spouse. "Grossly erroneous items" in section 6013(e)(1)(B) includes any item of gross income attributable to such spouse which is omitted from gross income. Sec. 6013(e)(2)(A). "Substantial understatement" in section 6013(e)(1)(B), (C), and (D) means any understatement of tax (as defined in section 6661(b)(2)(A)) which exceeds $500. Sec. 6013(e)(3). As discussed above, Cedrone's understatement of tax for the years 1971 and 1972 was substantially in excess of $500. Therefore, Mrs. Cedrone has satisfied the second requirement for relief under section 6013(e)(1)(B) as to the unreported payments made to Cedrone by Ron-Ore.

Section 6013(e)(1)(C) requires Mrs. Cedrone to establish that she did not know or have reason to know of the understatement of tax when she signed the return. In order to

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meet this burden she must prove (1) that she did not have actual knowledge of the understatement of tax, and (2) that the omission was not of such character as to cause a reasonably prudent person possessed of petitioner's experience and temperament to have known of the omission. These matters of proof are questions of fact. Sanders v. United States, 509 F.2d 162, 165 (5th Cir. 1975); Terzian v. Commissioner, 72 T.C. 1164, 1170 (1979); Mysse v. Commissioner, 57 T.C. 680, 697-699 (1972).

Mrs. Cedrone contends that she was experiencing depression during this period due to family and business problems. Though she had filed separately for years prior to 1971 to avoid involvement with her husband's business activities, she failed to study or read the returns filed jointly by them. Mrs. Cedrone claims that her marriage to Cedrone has lasted because of her refusal to interfere in his business affairs.

We are convinced that Mrs. Cedrone knew, or had reason to know, that there was a substantial understatement of income in the years 1971 and 1972. Mrs. Cedrone was not inexperienced in business affairs. She played a major role in operating Massaro during the 5 years following her father's death. Even more significantly, she was employed by Ron-Ore during the years at issue to maintain employee payroll records, quarterly tax returns, and compensation reports. Though Mrs. Cedrone never worked in Ron-Ore's company offices, she did have access to all payroll records and was responsible for computing and

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distributing wages. Participation in business affairs or bookkeeping has consistently been considered a factor in determining whether a spouse has reason to know of omissions from gross income. Quinn v. Commissioner, 62 T.C. 223 (1974), affd. 524 F.2d 617 (7th Cir. 1975). Considering Mrs. Cedrone's background in business and accounting, it is unreasonable, if not unbelievable, that she did not even read the joint returns.

Mrs. Cedrone's claim of ignorance of an understatement is further undermined by the substantial expenditures made on her behalf. In 1971, Cedrone wrote checks for $26,991.00 and $17,601.79 to purchase Mrs. Cedrone's home and to satisfy the outstanding mortgage on her rental property. These checks were drawn on Ron-Ore's account. Mrs. Cedrone admits that she knew Ron-Ore owed Cedrone and his companies money, but claims that these payments constituted loans by Cedrone to her. Regardless of the arrangements between petitioners--no evidence was submitted to indicate that the payments were in fact loans--Mrs. Cedrone's knowledge of Ron-Ore's obligations to Cedrone are incompatible with her claimed status of innocent spouse.

As to 1972, Cedrone paid for numerous improvements to Mrs. Cedrone's house with checks drawn on Ron-Ore's account. Mrs. Cedrone contends that these improvements to her home were made by and for Cedrone. Regardless of the motives behind such improvements, they are manifestations of earned and unreported income. Such unusual or lavish expenditures are to be

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considered in deciding whether a spouse has reason to know of omitted income. Mysse v. Commissioner, 57 T.C. 680, 699 (1972).

We find that Mrs. Cedrone knew of the understatement of tax caused by Cedrone's omission of income. Therefore, she fails to meet the third requirement under section 6013(e). Consequently, we need not determine whether, taking all of the facts into consideration, it would be inequitable to hold her liable for the deficiency attributable to the omissions of income. We hold for respondent on this issue.

The next issue for decision is whether petitioners are liable for additions to tax for fraud pursuant to section 6653(b) for each of the years in issue. We recognize that fraud is not imputed from one spouse to another. Section 6653(b)(4); Hicks Co. v. Commissioner, 56 T.C. 982, 1030 (1971), affd. 470 F.2d 87 (1st Cir. 1972); Stone v. Commissioner, 56 T.C. 213, 227 (1971). Respondent has the burden of proving fraud by clear and convincing evidence. Rule 142(b); sec. 7454(a); Miller v. Commissioner, 51 T.C. 915, 918 (1969). In order to prove fraud, respondent must show that petitioner intended to evade taxes which he knew or believed he owed, by conduct intended to conceal, mislead, or otherwise prevent the collection of such taxes. Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968); Webb v. Commissioner, 394 F.2d 366, 377 (5th Cir. 1968), affg. a

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Memorandum Opinion of this Court. Additionally, respondent must prove fraud in each of the years involved. Drieborg v. Commissioner, 225 F.2d 216, 220 (6th Cir. 1955).

The presence or absence of fraud is a factual question to be determined by an examination of the entire record. Mensik v. Commissioner, 328 F.2d 147, 150 (7th Cir. 1964), affg. 37 T.C. 703 (1962); Otsuki v. Commissioner, 53 T.C. 96, 105-106 (1969). Since fraud can seldom be established by direct proof of intention, petitioner's entire course of conduct can often be relied on to establish circumstantially such fraudulent intent. Stone v. Commissioner, 56 T.C. 213, 223-224 (1971); Otsuki v. Commissioner, supra at 105-106. Petitioner's failure to come forward with evidence to dispute respondent's determination of deficiencies for the years in issue is not determinative of fraud, for a mere understatement of income does not establish fraud. Carter v. Campbell, 264 F.2d 930, 936 (5th Cir. 1959). A consistent pattern of underreporting substantial amounts of income over a period of years is, however, persuasive evidence of fraud. Holland v. United States, 348 U.S. 121, 139 (1954); Lollis v. Commissioner, 595 F.2d 1189, 1191 (9th Cir. 1979), affg. a Memorandum Opinion of this Court. Also, a taxpayer's failure to maintain accurate books and records may also constitute significant evidence of fraud. Lollis v. Commissioner, supra at 1192; Otsuki v. Commissioner, supra at 110.

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We are satisfied that respondent has carried his burden of proving fraud by clear and convincing evidence for each of the years at issue.

Cedrone negotiated an agreement with Marshall entitling him to a commission as manager of the Sewer Project equal to 10 percent of the contract price. In each of the years at issue, Cedrone withdrew from Ron-Ore bank accounts substantial sums of money as both commission and rental income. Whether the withdrawals were cashed, deposited in bank accounts held in Cedrone's name, paid in satisfaction of his personal debts, or paid in satisfaction of the debts of his businesses, each inured to Cedrone's benefit. Cedrone is an experienced and relatively sophisticated businessman who knew that some, if not all, of these withdrawals constituted taxable income. Respondent need not prove the precise amount of underpayments resulting from fraud, but only that there was some underpayment and that some part of it was attributable to fraud. Otsuki v. Commissioner, supra; Estate of Brame v. Commissioner, 25 T.C. 824, 831-832 (1956), affd. 256 F.2d 343 (5th Cir. 1958).

Cedrone made numerous withdrawals in the name of fictitious payees. While this does not conclusively demonstrate fraudulent intent, it does constitute highly suspicious conduct that is not satisfactorily explained in the record. It may be that Cedrone was partially motivated by a

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desire to satisfy creditors of his businesses, but we conclude that this same conduct constitutes tax fraud and was undertaken with the intent to avoid payment of taxes known to be owing.

In support of his burden of proof with respect to the year 1972, respondent claims that petitioner is estopped from denying fraud because of his criminal conviction under section 7201 for that year. The law is clear that a criminal conviction based upon an indictment charging a willful attempt to evade or defeat tax necessarily carries with it the ultimate factual determination that the underpayment was due to fraud. Amos v. Commissioner, 43 T.C. 50 (1964), affd. 360 F.2d 358 (4th Cir. 1965). The result is the same where the taxpayer has been convicted of a section 7201 violation by virtue of his guilty pleas. Arctic Ice Cream Co. v. Commissioner, 43 T.C. 68 (1964). Thus, petitioner is estopped from denying the existence of fraud for the year 1972.

Pursuant to section 6653(b), an addition to tax for fraud is premised upon the existence of an underpayment of tax required to be shown on a return. In the absence of an underpayment, there is no basis for the addition to tax. Due to Cedrone's loss on the sale of his Scriba, New York, property, there was no underpayment of tax for the year 1970, and thus there is no section 6653(b) addition to tax for that year.

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For the years 1971 and 1972, we conclude that the underpayment in tax was due to fraud, and that Cedrone is liable for an addition to tax under section 6653(b) for each of those years.

The final issue for decision is whether Mrs. Cedrone is liable for the section 6653(b) addition to tax for fraud. Pursuant to section 6653(b)(4), in the case of a joint return, an addition to tax for fraud will not apply with respect to the tax of the spouse unless some part of the underpayment is due to the fraud of such spouse. It is possible that Mrs. Cedrone was unaware of the magnitude of Cedrone's unreported income. We are convinced, however, that "some part of the underpayment" for both 1971 and 1972 is due to fraud on Mrs. Cedrone's part. She was maintaining Ron-Ore's payroll records. She set up bank accounts in which Ron-Ore funds were deposited and held in trust for her sons. She lived in a house that was paid for and improved with Ron-Ore funds concededly owed to Cedrone and omitted from his income. She received, and failed to report, income from investment property partially paid for with Ron-Ore funds.

Having listened to Mrs. Cedrone's testimony, and having been impressed by her business acumen and her management of the

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Cedrone family finances, we hold her to be liable for the section 6653(b) addition to tax for fraud for the years 1971 and 1972.

Decision will be entered under Rule 155.

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T. C. Memo. 1986-90

UNITED STATES TAX COURT

OWEN GILLIAM III AND MARY L. GILLIAM, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 6690-84. Filed March 5, 1986..

Owen Gilliam III and Mary L. Gilliam pro se.

Marilyn Devin, for the respondent.

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MEMORANDUM FINDINGS OF FACT AND OPINION

AARONS, Special Trial Judge: This case was heard pursuant to section 7456(d)(3) of the Internal Revenue Code and Rules 180, 181 and 182 of the Tax Court's Rules of Practice and Procedure.[1]

Respondent determined a deficiency in petitioners' Federal income tax for the year 1980 in the amount of $5,947, with additions to tax under sections 6651(a) and 6653(a) of $189 and $297, respectively. After concessions by petitioners as set forth in the Stipulation of Facts, the following issues remain: (1) whether petitioners failed to include $5,000 of gross receipts on their Schedule C; (2) whether certain deductions other than depreciation on petitioners' Schedule C are allowable; (3) whether the depreciation claimed on petitioners' Schedule C is allowable; (4) whether the interest expense claimed on Schedule A is allowable; (5) whether Owen Gilliam's educational expenses are allowable; (6) whether Owen Gilliam's miscellaneous employee business expenses are allowable; (7) whether petitioners are entitled to an investment tax credit for the business use of their residence; (8) whether petitioners are entitled to a political contributions credit; and (9) whether petitioners are liable for the above mentioned additions to tax. Adjustments to petitioners' medical expense deduction and self-employment tax will turn automatically on the resolution of these issues.

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[1] Section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. Rule references are to the Tax Court Rules of Practice and Procedure.

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To the extent stipulated the facts are so found. Petitioners Owen and Mary Love Gilliam are husband and wife and resided in Los Angeles, California at the time of filing their petition.

Throughout 1980, Owen was employed full-time as a computer programmer for the Honeywell Corporation. In May of that year petitioners purchased their home, together with the accoutrements of a child care business, from a former child care operator, and established as a sole proprietorship the Love Infant Care Center (the "Center") at their residence. The purpose of the Center was to provide day care services for children six months to three years old. Petitioners charged approximately $50 per child per week for this service and cared for approximately 10 children each day throughout 1980. The main issues before us involve the Center's gross receipts and deductions.

The issues presented in this case are primarily factual. Petitioners have the burden of proof. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

For clarity, facts and law will be combined under the headings set forth below.

Schedule C Gross Receipts

On their 1980 Schedule C petitioners reported $19,504 in gross receipts. In the notice of deficiency respondent increased petitioners' gross receipts by $5,000. This increase was based upon total deposits during 1980 of $29,763 in the Center's Security Pacific National Bank business account. The revenue

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agent who audited petitioners' records noticed the $10,259 difference between the amount deposited in the account and the amount reported on their return and inferred that $5,000 of this difference represented unreported gross receipts from the Center's activities. Petitioners contend that the entire difference is comprised of an initial start-up deposit and ongoing contributions to capital made from their other accounts.

This case was initially set for trial on October 30, 1985. On that date petitioners introduced into evidence the Center's bank statements which set forth the 1980 transactional activity of that account. However, it soon became apparent to the Court that petitioners could not distinguish entries on these statements which represented contributions to capital from those representing receipts from business operations. Rather than being subjected to a lengthy audit session in order to do what our Rules require of the parties prior to trial (see Rule 91), we continued the matter until November 5, 1985. The Court instructed petitioners to meet with respondent in order to narrow this and other issues for trial.

During the interim petitioners prepared a spread sheet which purported to detail the source of the deposits to the Center's bank account which were not generated by the Center's operations. This spread sheet shows various withdrawals from petitioners' other accounts at Bank of America, Honeywell Credit Union and other minor sources. These withdrawals total $9,627.46 for 1980. Petitioners testified that the $50 per week that they charged for

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each child was not enough to make the Center self-sustaining and therefore all of the withdrawals were deposited into the business account in order to meet operating requirements. Respondent argued that the spread sheet merely listed petitioners' withdrawals from other accounts and did not establish how much, if any, of these withdrawals were actually deposited in the Center's business account.

The Court realizes that reconstruction of income five years after the fact is a difficult task. Petitioners spread sheet and supportive testimony were helpful in tracing some of the amounts withdrawn from the other accounts. However, petitioners did not persuade the Court that the entire $5,000 in dispute represented capital contributions. In a situation such as this the Court has the authority to make an approximation, although we are cautioned to "bear heavily" against a taxpayer where proof is lacking. Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). Accordingly, based upon the entire record herein and using our best judgment, we find and hold that petitioners' Schedule C gross receipts should be increased by $3,000.

Schedule C Deductions

Petitioners claimed $27,643 in total deductions (exclusive of depreciation) on their Schedule C. Since respondent allowed $20,884 of these deductions in the notice of deficiency, $6,579 remained in dispute at the beginning of trial.

As the November 5th trial progressed it became apparent to the Court that neither respondent nor petitioners could identify

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which of the deductions had been allowed or disallowed in the notice of deficiency. Again faced with the inappropriate alternative of conducting a full-blown audit session, the Court called a recess during which the parties held extensive negotiations and agreed that the amounts listed below were in issue.

Regarding the items listed below petitioners presented some documentary evidence and their own testimony in an attempt to meet their burden of proof. Based upon the scanty record herein--in some cases there was no proof whatsoever--and using our best judgment, under the authority of Cohan v. Commissioner, supra, we find and hold that petitioners are entitled to additional deductions as listed in the last column of the schedule set forth below.

Item	Amount Claimed On Schedule C	Amount Conceded by Respondent	Amount In Issue	Additional Amount Allowed by the Court
Car Expenses	$ 1,560	$ 0	$1,560	$ 780
Dues & Publications	75	10	65	0
Office Supplies and Supplies	3,528	2,834	694	0
Repairs	1,258	0	1,258	800
Telephone	502	251	0*	--
Utilities	330	247	0*	--
Wages	10,317	8,600	550*	0
Refunds	465	275	190	95
Taxes	835	649	0*	--
Miscellaneous	628	332	296	0
Food	1,916	0	1,916	1,816
Advertising	500	518	0	--
Bank Costs	25	42	0	--
Interest Expense	4,327	4,327	0	--
Laundry	685	685	0	--
Legal & Professional Services	350	470	0	--
Postage	125	125	0	--
Real Estate Tax	217	217	0	--

*The parties agree that these are the correct amounts in issue.

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Depreciation

On their Schedule C petitioners deducted $3,617 for depreciation, of which respondent allowed $2,406 in the notice of deficiency.

This issue concerns primarily the basis of the Center's building and furniture. Petitioners bought their house for $150,000. They used one-half of this figure as the basis to compute the Center's depreciation. Respondent allocated 60 percent of the purchase price to the building and 40 percent to the nondepreciable land. After a minor adjustment respondent's allocation to the building amounted to $88,950. Respondent then allocated one-half of the building's value to the Center, i.e. $44,475, and computed depreciation on this amount.

We believe that respondent's allocation with respect to the building was fair and reasonable, and we sustain his position on this issue.

As to the basis of petitioners' furniture, respondent computed depreciation on a $1,750 basis. Petitioners had claimed that their furniture had a $6,000 basis and offered a listing of all their pieces and their purported cost. This listing was entirely hearsay and can be given no weight. Petitioners offered no receipts or other evidence to prove the cost of the furniture. Respondent presented a witness who testified that the furniture was in a somewhat used condition. Based upon the record, we sustain respondent's position.

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Interest Expense

The fourth issue before the Court concerns petitioners' Schedule A interest expense deduction of $4,472. Of this amount, respondent allowed $3,277 in the notice of deficiency, and an additional $128 after discussions with petitioners. Therefore, $1,067 remains in dispute. It is petitioners' burden to provide substantiation for this amount.

Petitioners contend that they were not allowed interest paid of $799.37 on a United California Bank (UCB) loan, $204 to Honeywell Credit Union and $64 on a Century Bank credit card. Regarding the UCB loan, petitioners provided a bank statement showing a finance charge of $799.37 on a 10 year loan. This was the total finance charge over the life of the loan, not just the interest that accrued in 1980. The statement shows no repayment schedule of how or when this charge was to be paid. Owen testified that the interest was paid throughout the life of the loan at an 18-percent rate. He also testified that the Honeywell interest was incurred monthly on a car loan. Although the documentary substantiation provided by petitioners was scanty, we believe that Owen's testimony on these items warrants some additional allowance. Again bearing heavily against petitioners, we find that petitioners incurred $100 in allowable interest expense in addition to the amount already conceded by respondent. Cohan v. Commissioner, supra.

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Educational Expenses

Petitioners deducted $1,518 on their Form 2106 - Employee Business Expenses for Owen's educational expenses. Of this amount, $618 represented tuition and book cost for Owen's courses at California State University, Dominguez Hills (CSUDH), while the balance (i.e. $900) was purportedly incurred for transportation between petitioners' home and CSUDH. Respondent concedes that petitioners have substantiated $595 in tuition and books, but contends that the entire expense is nondeductible as a matter of law under section 1.162-5(b)(3), Income Tax Regs.

Owen was told by his supervisor at Honeywell that taking college level courses would improve his chances for promotion above his current grade T-5 level. Wanting his career to progress, Owen enrolled in night business and computer programming classes at CSUDH. His principal duties as a T-5 were to program and repair computers. A promotion to grade T-6 or C-6 status would still require him to program computers, and also allow him to be involved in management level decisions such as handling reports, scheduling and planning more complex programs.

Under section 1.162-5, Income Tax Regs., educational expenditures which meet certain criteria are considered deductible business expenses. In order to be deductible as a business expense, education which is not undertaken to meet the express requirements of a taxpayer's employer must be shown to maintain or improve the skills required by the individual in his employment. However, under section 1.162-5(b)(3), Income Tax

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Regs., even though the education does meet the express requirements of the taxpayer's employer or does improve the skills of a taxpayer in his employment, the expenses are not deductible if they are for education which is part of a program of study leading to qualifying the taxpayer in a new trade or business.

Here Honeywell did not require Owen to take business and computer classes. It was merely suggested that he should further his education to enhance his possibilities for promotion. Based upon the T-5 job description given by Owen, we believe that these classes helped maintain and improve his skills as a computer programmer and repairman. Furthermore, based upon Owen's credible testimony on this issue, a promotion to grade 6 status would not be considered a new trade or business since it involves basically the same general skills and requirements as a T-5, but with greater responsibilities. Accordingly, petitioners' deduction for tuition and books is allowed to the extent that it was substantiated, i.e. $595.

The remaining $900 of petitioners' educational expenses deduction represents mileage driven by Owen between his home and CSUDH. Each weekday after returning home from work Owen would drive 50 miles round trip to his night classes at CSUDH. He claims that he drove 250 miles each week for nine months for a total of 9,000 miles driven for education in 1980. His return

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shows a deduction of only $900 for transportation. Legally, the situation presented is indistinguishable from Boerner v. Commissioner, T.C. Memo. 1971-54, in which we determined that the deduction should be limited to the excess transportation costs over what it otherwise would have cost the taxpayer to commute between his job and his home. We hold that petitioners are entitled to an educational transportation expense deduction, but we limit the deduction to the amount claimed on the return (i.e. $900).

Miscellaneous Deductions

Petitioners deducted $350 as a miscellaneous employee business expense. At trial, petitioners maintained that this amount represented mileage expense for Owen's unreimbursed transportation between various Honeywell plants in West Covina, Azusa, City of Industry and San Diego. Owen testified that he drove 1,800 miles between plants in 1980 for which he received no reimbursement. He also presented a log book for respondent's inspection (as to which respondent questioned the dates of the entries made) but did not request that this log be admitted into evidence. It is not clear from the record how petitioners computed the $350 expense.

Unreimbursable transportation expenses incurred between two places of business are deductible. Steinhort v. Commissioner, 335 F.2d 496, 503-505 (5th Cir. 1964), affg. and remanding a Memorandum Opinion of this Court. It is, therefore, clear that

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Owen's unreimbursed trips between Honeywell plants are deductible. However, petitioners presented inadequate evidence to substantiate the number of miles driven or the expenses incurred. We find and hold that petitioners are entitled to a $175 transportation deduction. Cohan v. Commissioner, supra.

Investment Tax Credit and Political Contributions Credit

In September of 1982 petitioners filed a Form 1040X Amended Tax Return on which they claimed a $750 investment tax credit on property they valued at $75,000. At trial petitioners maintained that the credit should have been $7,500, i.e. 10-percent of $75,000. Respondent has disallowed any claim for this credit.

Petitioners testified that the $75,000 figure represented the amount of purchase price allocated to their house (apart from their land). However, the investment tax credit does not apply to buildings. Section 48(a)(1)(B); section 1.48-1(a), Income Tax Regs. Accordingly, respondent's position must be sustained.

Petitioners' $2 political contributions credit was disallowed by respondent, and since no proof was offered at trial we sustain respondent's position.

Additions to Tax Under Sections 6651(a) and 6653(a)

In the notice of deficiency respondent determined additions to tax under sections 6651(a) and 6653(a) in the amounts of $189 and $297, respectively. With regard to the section 6651(a) late

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filing addition, Owen testified that his 1980 return was timely filed. However, the return was dated "5/1/81" and no evidence of any extensions was introduced. Accordingly, we must sustain respondent's section 6651(a) addition.

Turning to the section 6653(a) negligence addition, we note that petitioners' record keeping has been less than exemplary. They offered no proof to rebut the presumption of correctness attached to respondent's determination under section 6653(a). Accordingly, we sustain respondent's position on this issue. See Bixby v. Commissioner, 58 T.C. 757, 791-2 (1972).

To reflect the foregoing,

Decision will be entered under Rule 155.

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UNITED STATES TAX COURT

PATRICK J. MALONEY, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 17617-80. Filed March 10, 1986.

Cyril L. Lawrence, for the petitioner.

Bryce Kranzthor, for the respondent.

PARR, Judge:* Respondent determined a deficiency in petitioner's 1976 Federal income tax in the amount of $184,655.

This case involves the validity of respondent's notice of deficiency. Specifically, the issues presented for decision are (1) whether petitioner's 1976 tax year was closed, so as to prevent respondent from determining further deficiencies; (2)

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* By order of the Chief Judge, this case was reassigned to Judge Parr for decision and opinion.

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whether respondent failed to follow its own procedural rules for reopening a closed year, and, if so, whether such failure invalidates the notice of deficiency; and (3) whether respondent conducted a second inspection of petitioner's books of account for 1976, in violation of section 7605(b),[1] and, if so, whether such violation invalidates the notice of deficiency. In the event the Court upholds the validity of the notice, the parties have reached a settlement regarding the various adjustments to income raised in the notice.

FINDINGS OF FACT

The facts have been stipulated and are so found. The case was submitted to this Court without trial pursuant to Rule 122.

At the time of filing the petition in this case, petitioner resided in Merced, California.

Petitioner timely filed his 1976 Federal income tax return on July 15, 1977, pursuant to an extension of time requested by petitioner. Petitioner's 1973, 1975 and 1976 returns were subsequently selected for audit.[2] Respondent submitted an examination report explaining proposed adjustments to these returns on May 3, 1979. The report proposed a disallowance of

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1 All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue, and any references to rules are to the Tax Court Rules of Practice and Procedure.

2 It is not clear whether petitioner's 1974 income tax return was also examined. Petitioner's 1977 return was apparently also examined, but was not included in the same examination report.

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$87,062 of petitioner's 1976 partnership loss of $131,386 from Sunshine Associates. Petitioner's 1976 loss from Gibraltar Associates, in the amount of $24,073, was not included in the report as a proposed disallowance.

On June 29, 1979, petitioner executed a Form 870, Waiver of Restrictions on Assessment and Collection,[3] agreeing to the proposed deficiencies for 1973, 1975, and 1976 in the amounts of $2,736, $3,555, and $27,625, respectively. He remitted the amount of taxes and interest due. By letter dated September 25, 1979, respondent notified petitioner that the revenue agent's examination report had been reviewed and accepted.

By letter dated February 4, 1980, respondent informed petitioner that Sunshine Associates and Gibraltar Associates were under audit by a second revenue agent, and that adjustments might be proposed to the partnerships' returns which might affect petitioner's 1976 return. The revenue agent requested that petitioner sign a Form 872, Consent to Extend the Time to Assess

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[3] The form reads in pertinent part:

> "Your consent will not prevent you from filing a claim for refund (after you have paid the tax) if you later believe you are so entitled nor prevent us from later determining, if necessary, that you owe additional tax; nor extend the time provided by law for either action.
>
> If you later file a claim and the Service disallows it, you may file a suit for refund in a district court or in the United States Court of Claims, but you may not file a petition with the United States Tax Court * * *."

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Tax, since it was unlikely the partnership audit would be completed before petitioner's statute of limitations expired. Petitioner refused to extend the statute of limitations for his 1976 income tax return, stating that respondent was estopped from determining additional deficiencies since petitioner had agreed to the prior adjustments.

The revenue agent conducting the examination of the partnerships then initiated a request to reopen petitioner's 1976 tax year.[4] The request was made on March 4, 1980, on a Form 4505, Reopening Memorandum. The reason for the request was marked as "serious administrative omission resulting in criticism, undesirable precedent, or inconsistent treatment." The agent's request was subsequently approved by the District Director on March 19, 1980, after three intermediary levels of review.

Following the reopening of the case, respondent again requested that petitioner agree to extend the statute of limitations for his 1976 return. Petitioner again refused to sign the consent.

On July 15, 1980, respondent timely mailed a notice of deficiency to petitioner relating to his 1976 return. The notice stated that petitioner's loss from Gibraltar Associates and the remainder of his loss from Sunshine Associates were disallowed in the absence of verification and substantiation of the partnership

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[4] The request also related to petitioner's 1977 tax return, which is not at issue here.

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items. In addition, petitioner's basis was reduced and his taxable income increased by the amount of his share of the disallowed nonrecourse note and other partnership liabilities. The deficiency determined was $184,655.

OPINION

Petitioner contends that the examination of his 1976 income tax return was closed pursuant to an agreement with respondent. This contention appears to be based on his execution of a Form 870 agreeing to respondent's deficiency for that year, and on respondent's subsequent letter stating that the examination report was accepted. Petitioner does not allege, nor do the facts indicate, that these documents constitute a formal written closing agreement, as provided in section 7121. That section sets forth the exclusive procedure under which a final closing agreement as to the tax liability of any person can be executed. Estate of Meyer v. Commissioner, 58 T.C. 69, 70 (1972). See also Botany Worsted Mills v. United States, 278 U.S. 282, 288 (1929).

The form signed by petitioner, entitled Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment, does not constitute a binding closing agreement under section 7121. The Form 870 is merely a waiver by petitioner of the statutory notice requirements imposed upon respondent by section 6213(a). Consolidated Freightways, Inc. v. United States, 620 F.2d 862, 868 (Ct. Cl. 1980).

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The very language of the Form 870 executed by the parties in this case indicates an intent not to be bound. Joyce v. Gentsch, 141 F.2d 891 (6th Cir. 1944). The form expressly states that petitioner may later file a claim for refund and that respondent is not prevented from later determining that additional tax is owed.[5] By its own terms, therefore, the Form 870 did not purport to be a final closing agreement, and did not prevent respondent from determining additional deficiencies relating to the same tax years.

The September 25, 1979, letter sent to petitioner informing him that his examination report was accepted likewise was not a closing agreement, and did not bar a subsequent notice of deficiency. Such letter merely indicated that for administrative purposes, the examination was closed. Petitioner concedes that respondent has procedures which allow for the reopening of such cases where necessary.

As a corollary to this argument, petitioner maintains that because he agreed to the deficiencies and paid the tax due, he has been prejudiced, and respondent is therefore estopped from issuing the notice of deficiency. We cannot find any grounds for equitable estoppel here. Petitioner has not established the existence of the traditional elements of equitable estoppel, particularly a binding representation on which petitioner relied

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5 In fact, petitioner agreed in this Form 870 to an additional tax owed for 1975, although he had previously executed a similar waiver form agreeing to an amount of tax due for that year.

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to his detriment. See Consolidated Freightways, Inc. v. Commissioner, 74 T.C. 768, 791 (1980), affd. on other issues 708 F.2d 1385 (9th Cir. 1983). Respondent made no representation that he would not issue an additional notice of deficiency. Furthermore, petitioner's position was in no way prejudiced as a result of his execution of the Form 870 as he could sue for a refund at any time.

We therefore hold that there was no binding closing agreement, and respondent was not estopped from issuing his notice of deficiency.

Petitioner next argues that respondent improperly reopened his closed 1976 tax year by failing to follow his internal procedures for reopening closed cases.

Respondent's procedures for reopening closed cases are set forth in Rev. Proc. 74-5, 1974-1 C.B. 416.[6] In pertinent part, the revenue procedure reads as follows:

> Section 1. Purpose
>
> The purpose of the Revenue Procedure is to restate and amplify the conditions under which a case closed after examination in the office of a District Director of Internal Revenue may be reopened to make an adjustment unfavorable to the taxpayer.
>
> * * *

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6 This revenue procedure is the predecessor of Rev. Proc. 83-19, 1983-1 C.B. 677, cited by petitioners, which has since been superseded by Rev. Proc. 85-13, 1985-1 C.B. 514.

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Sec. 3. Definitions

.01 Closed Case:

1. A case agreed at the district level is considered closed when the taxpayer is notified in writing, after district conference, if any, of adjustments to tax liability or acceptance of his return without change.

* * *

.02 Examination and Reopening:

1. Contacts with taxpayers to verify or adjust items disclosed on information returns, including items of income distributable to taxpayers by partnerships, * * * are not examination or reopenings.

* * *

Sec. 4. Policy

.01 The Internal Revenue Service will not reopen any case closed after examination by a district office, service center or Office of International Operations to make an adjustment unfavorable to the taxpayer unless:

1. There is evidence of fraud, malfeasance, collusion, concealment or misrepresentation of a material fact; or

2. The prior closing involved a clearly defined substantial error based on an established Service position existing at the time of the previous examination; or

3. Other circumstances exist which indicate failure to reopen would be a serious administrative omission.

.02 All reopenings must be approved by the District Director or by the Director of International Operation for cases under his jurisdiction. If an additional inspection of the taxpayer's books of account is necessary, the notice to the taxpayer required by section 7605(b) of the Code must be signed by the District Director, or by the Director of International Operations for cases under his jurisdiction.

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As stated in the revenue procedure, a case agreed at the district level is considered administratively closed when the taxpayer is notified, in writing, of adjustments to tax liability or acceptance of his return without change. Respondent concedes that petitioner's 1976 tax year was administratively closed within the meaning of Rev. Proc. 74-5.

Petitioner contends that the revenue agent did not obtain the necessary authorization for the reopening. Petitioner argues, in addition, that respondent did not comply with the policies stated in the revenue procedure, in that respondent did not establish fraud, collusion, concealment, misrepresentation, or substantial error at the time of reopening. Petitioner also points out that respondent's procedures require that a notice of re-examination be delivered to the taxpayer at the time the re-examination is begun.

We find that respondent has complied with the above revenue procedure, and that petitioner's contentions are without merit. As required by the revenue procedure, the reopening request was approved by the District Director. The revenue agent, in requesting the reopening, marked as the reason "serious administrative omission resulting in criticism, undesirable precedent, or inconsistent treatment," and expanded further in an accompanying memorandum. Petitioner's last allegation, regarding the notice of re-examination, is discussed further below, and is also without merit.

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Moreover, we find that, under respondent's procedures, no "reopening" occurred here. The revenue procedure specifically states that "[c]ontacts with taxpayers to verify or adjust items disclosed on information returns, including items of income distributable to taxpayers by partnerships * * * are not examinations or reopenings."

The facts are undisputed that, following the original examination of petitioner's return, respondent sought to redetermine his tax liability for that year only with respect to partnership items which might be affected as a result of audits of the partnerships. Adjustments of items flowing through to petitioner from partnership returns are not considered reopenings of petitioner's return under Rev. Proc. 74-5, and we therefore find that respondent did not have to comply with the policies and procedures for reopening cases set forth in that revenue procedure.[7]

Although we find no violation of respondent's procedural rules, and therefore need not decide whether any such violation would invalidate the notice of deficiency, we note that procedural rules such as the one cited above are directory, not mandatory. Collins v. Commissioner, 61 T.C. 693 (1974); Geurkink

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7 The reopening memorandum indicates that petitioner's counsel agreed with the revenue agent, at the time of the reopening, that no reopening was required to flow through a partnership adjustment to a previously examined return. The revenue agent felt, however, that a formal reopening would be the wisest course to protect the Service against possible taxpayer argument and criticism.

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v. United States, 354 F.2d 629 (7th Cir. 1965). Compliance with such procedures is thus not essential to the validity of a notice of deficiency. Luhring v. Glotzbach, 304 F.2d 560 (4th Cir. 1962).

In addition, petitioner argues that because respondent violated his procedural rules to petitioner's prejudice, respondent was estopped from issuing the notice of deficiency. Petitioner relies on Narragansett Wire Co. v. Commissioner, 491 F.2d 371 (1st Cir. 1974), affg. a Memorandum Opinion of this Court, for this proposition. In that case, the First Circuit suggested, in a footnote, that a violation of a procedural rule which is shown to have prejudiced a taxpayer's position may bar a subsequent assessment of a deficiency. Narragansett Wire Co. v. Commissioner, supra at 393-394 n. 6. Because of our finding that no violation of respondent's procedures occurred, we need not consider this argument.

We hold for respondent on this issue.

Petitioner's main contention is that respondent, in reopening his 1976 tax year and determining additional tax deficiencies for that year, conducted a second inspection of his books of account as prohibited by section 7605(b).

Section 7605(b) reads as follows:

> No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

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Petitioner argues that respondent's letter of September 25, 1979, informing petitioner that the examination report had been accepted, was a closing letter clearly establishing the end of the audit, and that any subsequent inspection of the books of account must comply with section 7605(b). Respondent does not contest the fact that the examination was completed, but argues that no prohibited second inspection ever took place and that therefore section 7605(b) was not violated. For the reasons stated below, we agree with respondent and find no violation of section 7605(b).

The purpose of section 7605(b) was to prevent the Internal Revenue Service from undertaking repetitive investigations as a method of taxpayer harassment. The statute was not meant to restrict the scope of the Commissioner's legitimate power to protect the revenue. United States v. Powell, 379 U.S. 48 (1964); Collins v. Commissioner, supra. Therefore, it is not to be read so liberally as to defeat the powers granted to the Internal Revenue Service to examine the correctness of taxpayers' returns. De Masters v. Arend, 313 F.2d 79 (9th Cir. 1963), cert. dismissed 375 U.S. 936 (1963).

In the instant case there is no evidence of repetitive audits of petitioner. Petitioner's books and records for 1976 were examined once, and the examination was concluded[8] upon the acceptance of the examination report. The notice of deficiency

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[8] As noted above, for administrative purposes, petitioner's examination was considered closed.

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subsequently mailed to petitioner was not a result of any second inspection of his books of account. It appears from the reopening memorandum that the second revenue agent, at most, inspected petitioner's 1976 tax return and the original examination report. This does not constitute an inspection of a taxpayer's books of account. Pleasanton Gravel Co. v. Commissioner, 64 T.C. 510 (1975), affd. per curiam 578 F.2d 827 (9th Cir. 1978, cert. denied 439 U.S. 1071 (1979); Benjamin v. Commissioner, 66 T.C. 1084 (1976), affd. 592 F.2d 1259 (5th Cir. 1979).

Respondent did conduct an examination of petitioner's partnerships. It is well settled that an inspection of a third party's books of account which gives rise to an adjustment on a taxpayer's return does not constitute a second inspection of that taxpayer's books in violation of section 7605(b). See Grossman v. Commissioner, 74 T.C. 1147 (1980), appeals dismissed (9th Cir. 1981) (taxpayer's brother's return); Geurkink v. United States, supra (taxpayer's wholly owned corporation's return); Benjamin v. Commissioner, supra (taxpayer's controlled corporation's return); Kolom v. Commissioner, 644 F.2d 1282 (9th Cir. 1981), affg. 71 T.C. 235 (1978) (taxpayer's corporate employer's return); Collins v. Commissioner, supra (taxpayer's private foundation's return). Although the instant case involves a partnership, which is not a separate taxpayer, we are convinced that an inspection of a limited partnership also cannot be viewed as an examination of the limited partners' books of account.

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In Moloney v. United States, 521 F.2d 491 (6th Cir. 1975), cert. denied 423 U.S. 1017 (1975), the Sixth Circuit held that the audit of a general partnership did constitute a second inspection of the books of its two general partners. The court stated that

> Since the partnership itself was not a taxable entity but merely an extension of the persons of the taxpayers themselves, partnership records were necessarily personal records and entitled to the statutory protection in the absence of a notice reopening the inspection. Moloney, supra at 501.

However, where an examination of a limited partnership was at issue, this Court held that an inspection of the limited partnership's books is not an inspection of the limited partners' books. In Curtis v. Commissioner, 84 T.C. 1349 (1985), we held that, under facts similar to those before us, a limited partnership may have an institutional identity sufficient to distinguish an inspection of its books of account from an inspection of a partner's books for purposes of section 7605(b). The taxpayer in Curtis was a 9.5 percent limited partner in a limited partnership based in a different state. The taxpayer was an investor without physical possession of the books and records of the partnership, and with only a restricted right to participate in the management of the partnership. The Court distinguished the facts of Moloney v. United States, supra, and found that an inspection of the books of the limited partnership was more like an inspection of the books of a corporation for purposes of section 7605(b).

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In the case before us, petitioner owns a 9.7 percent interest in each of two limited partnerships. Nothing in the record indicates that petitioner is anything but an investor in these partnerships. We therefore cannot find, as in Moloney, that these limited partnerships are an extension of petitioner, or that the partnership records are his personal records. We hold that, under the facts of this case, the inspection of the books of Sunshine Associates and Gibraltar Associates was not an inspection of the books of its limited partners, and thus did not constitute a prohibited second inspection of petitioner's books of account.

We hold for respondent on this issue.

Because we find no violation of section 7605(b), we need not decide whether such violation would invalidate the notice of deficiency.

Due to necessary computations in accordance with the agreement of the parties,

Decision will be entered under Rule 155.

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T. C. Memo. 1986-92

UNITED STATES TAX COURT

LAWRENCE L. AND MARY B. MELTON, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 9372-84. Filed March 10, 1986.

Petitioner's employment as a journeyman electrician at the North Anna Nuclear Power Plant in Mineral, VA, was not "temporary." Petitioner's expenses in travelling between Mechanicsville, VA, where he lived, and Mineral, VA, where he worked, are not deductible.

Lawrence L. and Mary B. Melton, pro se.

Richard F. Stein, for the respondent.

MEMORANDUM OPINION

DRENNEN, Judge: Respondent determined deficiencies in petitioners' Federal income tax as follows:

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Year	Deficiency
1981	$1,642.00
1982	1,528.00

The issue for our decision is whether travel expenses incurred by petitioner Lawrence L. Melton[1/] in travelling from his residence to his place of employment are deductible as ordinary and necessary business expenses pursuant to section 162.[2/]

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and joint exhibits are incorporated herein by this reference. For convenience, and to facilitate our disposition of this case, we have combined our findings of fact and opinion.

Petitioners Lawrence L. and Mary B. Melton are husband and wife and resided in Mechanicsville, Virginia with their two children at the time they filed their petition in this case. They have owned their present home since sometime in 1975. Petitioners filed a timely joint Federal income tax return for the taxable years 1981 and 1982 with the Internal Revenue Service Center in Memphis, Tennessee.

1/ All references to petitioner refer to Lawrence L. Melton.

2/ All section references are to the Internal Revenue Code of 1954, as amended, and in effect during the taxable years at issue. All rule references are to the Tax Court Rules of Practice and Procedure.

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Petitioner is an electrician and a member of Local 666 of the International Brotherhood of Electrical Workers (Local 666). Local 666 is based in Richmond, Virginia. When he joined Local 666, petitioner completed the requirements for classification as a journeyman wireman.

Local 666 had jurisdiction over the assignment of electricians to the construction by Virginia Electric Power Company (VEPCO), of North Anna Nuclear Power Plant (North Anna). From 1974 to 1980, petitioner was employed at North Anna in Mineral, Virginia by electrical engineers Fischbeck and Moore, and H. P. Foley, during the construction phase of the plant. From November 1980 until May 1983, petitioner was employed at North Anna by Fruin Colon Corp., performing electrical maintenance work. Petitioner was referred to Fruin Colon Corp. by Wayne P. Stallard (Stallard), Assistant Business Manager of Local 666. Petitioner stated that when he began working for Fruin Colnon Corp., Stallard told him that the job would last six to eight months. The following letter was written by Stallard on April 27, 1983:

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To whom it may concern:

For some time we have been supplying electricians out of our hiring hall to the North Anna Power Station project.

Depending on the work load required by the project, sometimes the number of electricians working there is high, and at other times the project is laying off and the number of electricians employed there is low. Because of the constantly changing work load, it is very hard to say how long an electrician will be employed at the project.

Sincerely yours,

/s/ Wayne P. Stallard

During the time that petitioner worked at North Anna he lived in Mechanicsville, Virginia with his family and commuted back and forth to North Anna every day, a distance of 106 miles round trip."

During 1981, petitioner worked every week and a total of 339 days at North Anna. On their 1981 return, petitioners deducted $5,303 as employee business expenses based on petitioner's claim that he drove a total of 35,934 miles to and from North Anna in 1981. In 1982, petitioner worked a total of 353 days at North Anna. On their 1982 return, petitioners deducted $5,466 as employee business expenses based on petitioner's claim that he drove 37,418 miles to and from North Anna in 1982.

From January through May of 1983, petitioner worked every other week at North Anna, due to reductions in the work force. Petitioner stated that often in his line of work, employers would hire more people than they needed, or lay off more people than

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they should and then hire the people back. He stated that it was typical in his profession for workers to have difficulty finding continuous work.

Petitioner terminated his employment at North Anna in May 1983 when VEPCO entered into a new contract with Daniels Construction, a nonunion contractor. Within two months of his termination, petitioner began working in a nuclear plant in New Jersey.

Petitioner contends that the expenses he incurred in travelling from his home in Mechanicsville, Virginia to North Anna are deductible as ordinary and necessary business expenses. He urges us to find that his job with Fruin Colon Corp. was "temporary" in nature. Respondent contends that petitioner's job was "indefinite" in nature and therefore the expenses incurred were not deductible.3/

Section 262 provides that "no deduction shall be allowed for personal, living, or family expenses." In accordance with section 262, it is well settled that a taxpayer's expenditures for daily commuting between his home and place of employment are nondeductible personal expenses. Commissioner v. Flowers, 326 U.S. 465 (1946). The Courts, and respondent, however, have recognized an exception to this rule when the taxpayer's expenses are incurred in travelling to and from a temporary job outside of

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3/ Petitioner did not specifically agrue that his expenses were deductible as incurred "while away from home" under section 162(a). This argument would be unavailing unless petitioner could first survive section 262.

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his normal area of employment. McCallister v. Commissioner, 70 T.C. 505 (1978); Norwood v. Commissioner, 66 T.C. 467 (1976); Rev. Rul. 190, 1953-2 C.B. 303.

None of petitioner's jobs were "permanent" in nature. The impermanence of construction work, however, does not resolve the issue of whether petitioner's employment was temporary. Commissioner v. Peurifoy, 254 F. 2d 483, 486 (4th Cir. 1957), affd. per curiam 358 U.S. 59 (1958); Kasun v. United States, 671 F.2d 1059, 1061 (7th Cir. 1982).

In order to qualify for the deduction petitioner's job or jobs at the North Anna plant must have been "temporary" as contrasted with "indefinite" or "indeterminate." Commissioner v. Peurifoy, supra. The Fourth Circuit Court of Appeals, to which an appeal of this would lie, stated in Peurifoy that to come within the exception to the commuting rule:

> It is essential that the employment away from the established tax home shall be temporary in contemplation at the time of its acceptance and not indeterminate in fact as it develops. However justified he may be from a subjective or personal point of view in maintaining a residence away from his post of duty, his travel and maintenance expense at his post of duty is not an ordinary and necessary business expense *** if the employment is of substantial or indefinite duration. [254 F.2d at 486].

Temporary employment is employment that can be expected to last for only a short period of time. McCallister v. Commissioner, supra at 509. The employment must be temporary in contemplation at the time of its acceptance and not indeterminable in fact as it develops. McCallister v.

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Commissioner, supra. Petitioner bears the burden of proving that his employment was temporary. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

The only evidence presented by petitioner to support his contention that his job was "temporary" in nature is his own self-serving assertion, and also his claim that when he was employed by Fruin Colon Corp. he was told by Stallard that the job would last six to eight months. However, the letter written by Stallard and introduced into evidence by petitioner states that "...it is very hard to say how long an electrician will be employed at the project." In addition, petitioner himself acknowledged that it was difficult in his profession to have continuous work. He stated that often employers hired too many people and then had to lay them off, or laid off too many people and then had to hire them back. He stated that he, himself, never knew if he was "coming or going."

We find that petitioners have failed to carry their burden of proving that petitioner's job was "temporary" in nature. Petitioner's testimony in fact offers support for respondent's contention that the job was instead "indefinite." For by his own admission, petitioner was never sure how long a job would last. However, petitioner's experience in working at North Anna during the construction of the plant should have given him some assurance that his electrical maintenance job was not temporary. There is no evidence that petitioner was not well considered by his new employer. Moreover, respondent's contention is

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supported further by the, fact that petitioner ended up spending over two years in the employ of Fruin Colon Corp. and was terminated there only because his employer lost its contract.

Accordingly, for the reasons detailed above, we find that petitioner's employment at North Anna in 1981 and 1982 was "indefinite." Therefore, we sustain respondent's determination.

Decision will be entered for the respondent.

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UNITED STATES TAX COURT

ALBERT H. PAYNE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 16426-84. Filed March 10, 1986.

Albert H. Payne, pro se.

Irene Scott Carroll, for the respondent.

MEMORANDUM OPINION

AARONS, Special Trial Judge: This case was assigned to Special Trial Judge Lehman C. Aarons pursuant to section 7456(d)(3) of the Internal Revenue Code and Rules 180, 181 and 182 of the Tax Court Rules of Practice and Procedure.[1]

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[1] Section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. Rule references are to the Tax Court Rules of Practice and Procedure.

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Respondent determined a deficiency in petitioner's 1980 Federal income tax in the amount of $5,484, along with an addition to tax under section 6653(a) in the amount of $274. After concessions by both parties, the remaining issues to be decided are: (1) whether petitioner is entitled to certain Schedule C deductions claimed in relation to his engineering services business; (2) whether petitioner was in the trade or business of being an income tax consultant, and if so, whether his deductions claimed for this business are allowable; (3) whether petitioner is liable for self-employment tax; and (4) whether petitioner can carry back to 1980 a net operating loss generated in 1983.

To the extent stipulated, the facts are so found. Petitioner resided in Los Angeles, California, at the time he filed his petition. Petitioner filed his 1980 Federal income tax return under "married filing separately" status. His wife throughout 1980 was Shirley M. Payne. Petitioner and Mrs. Payne were subsequently divorced and she is not a petitioner herein.

Preliminarily, a fundamental principle common to all issues in this case must be noted. The issues are primarily factual. The factual determinations made by respondent in his notice of deficiency are presumed to be correct. Petitioner bears the burden of establishing error in those determinations. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

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For clarity, facts and law will be combined under the following headings.

ENGINEERING SERVICES EXPENSES

During 1980, petitioner worked as an architectural engineer, designing and supervising the alteration and rehabilitation of industrial offices. On his 1980 engineering Schedule C petitioner reported $26,543 of total income and claimed the following deductions from this business (also shown are the amounts that the parties agreed were deductible):

Description	Amount Claimed	Amount Agreed Deductible
Bank Charges	$ 92	
Car & Truck Expense	2,502	
Insurance	1,653	
Interest	554	$ 168.26
Laundry & Cleaning	85	
Legal & Professional	944	
Postage	188	125.00
Rent (office in home)	750	
Repairs	2,206	
Taxes	102	91.27
Telephone	4,956	
Travel & Entertainment	3,061	1,589.76
Post Office Box	28	
Printing	76	40.00
Schooling	1,817	
Books	178	
Messenger	26	
Telegrams	134	134.00
Gifts	846	
Membership	35	
Contributions	65	14.00
Subscriptions	108	72.00
Passport	15	
Utilities	146	
Tips	312	
Total	$20,879	

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It is respondent's contention that most of these items claimed by petitioner on his Schedule C represent personal expenditures rather than allowable business deductions.

Section 162(a) permits the deduction of ordinary and necessary expenses incurred in carrying on any trade or business. However, no deduction is allowed for personal living or family expenses. Sec. 262. There is no question that petitioner was in the office design business.

Telephone Expenses and Bank Charges: Petitioner deducted $4,956 in telephone expenses in 1980. However, his telephone bill shows only $4,216.43 in charges. Petitioner explained that this discrepancy was due to a mathematical error. At trial, petitioner estimated that $3,500 of the total telephone charges were for business calls.

Due to the voluminous nature of petitioner's 1980 telephone bill presented to the Court, the parties have agreed that the bill for January is a fair representation of petitioner's and his family's telephone usage throughout the year. Therefore, whatever percentage of business use we find for January will be applied to the remaining months to determine the total business usage for 1980. Petitioner also claimed $92 in bank charges. The parties also agreed to apply this same percentage to determine the business portion of petitioner's bank charges.

Petitioner testified that he used his home phone to call prospective employers, headhunters and job shops throughout the United States and all over the world in order to find work. In

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January 1980 he called, inter alia, Alaska (Alaska pipeline project), British Columbia (oil refinery job), and Scotland (fabrication plant job in Spain). He also testified that Mrs. Payne used the telephone to call friends in England and Santa Monica, California, and that his two teen-age sons used the telephone regularly.

There are approximately 160 charges listed on the January bill for long distance telephone calls and telegrams totaling $677.65, and approximately 60 local message unit charges totaling $14.40. At the trial, petitioner conceded that $108 of the long distance charges and $2.50 of the local charges were personal in nature and nondeductible.

Based upon the entire record herein and the approximation authority vested in the Court, Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930), we find that 40-percent of petitioner's January 1980 telephone calls and telegrams were business related. Accordingly, the same percentage of petitioner's 1980 telephone bill of $4,216.43 is deductible and the same percentage of petitioner's claimed $92 in bank charges is deductible.

Car and Truck Expenses and Repairs: In 1980 petitioner owned four automobiles: a 1964 Porsche, a 1975 Volvo Station Wagon, a Volkswagon Rabbit and a Ford Pinto. The Porsche was a classic car and was kept in storage. The Volkswagon was used primarily by Mrs. Payne, while petitioner drove the Volvo and the Ford. Neither of petitioner's sons used the cars.

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Petitioner claimed that 90-percent of his driving was for business. This driving consisted of trips to various job sites. Although petitioner stipulated to receiving gross receipts from six different employers throughout the United States, he provided testimony regarding driving trips to only one employer, Volt Technical Services. Petitioner made four or five round trips in his Volvo to Burlingame, California, while working for Volt. The distance from petitioner's residence in Los Angeles to the work site in Burlingame is approximately 400 miles. He would usually drive to the job site on Sunday night and return the following Friday morning. Petitioner also used his cars for local business trips.

Of the $2,502 claimed for car and truck expenses, petitioner could provide receipts for only $1,850.09 in gas and oil purhases and $44 for a road service club. The discrepancy between the amount claimed and the amount substantiated was not explained. Petitioner did not keep any log book of his business driving. Although detailed proof was lacking, using our best judgement we allow petitioner a deduction of $200 for local business transportation. Cohan v. Commissioner, supra.

Section 162(a)(2) allows the deduction of business traveling expenses incurred while away from home. Commissioner v. Flowers, 326 U.S. 465, 470 (1946); see also Peurifoy v. Commissioner, 358 U.S. 59, 60 (1958). However, deductions for business travel away from home are allowed only if they meet the strict substantiation requirements of section 274(d).

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With respect to the trips to Burlingame, although petitioner did not keep a log book, the proof that Burlingame was 400 miles away from his home satisfies the substantiation requirements of section 274(d). Smith v. Commissioner, 80 T.C. 1165, 1172 (1983). Accordingly under Smith, petitioner is entitled to a deduction for 3200 miles traveled (i.e. 800 miles per round trip times 4 trips) based upon the allowable standard mileage rate in effect in 1980. See Rev. Proc. 80-7, 1980-1 C.B. 590.

Petitioner offered no proof regarding his claimed deduction for car repairs. We do not know what kind of repairs were performed, which car or cars were repaired and whether these repairs were somehow related to petitioner's business. Accordingly, petitioner has not met his burden of proof and respondent must be sustained on this item.

Travel and Entertainment and Tips: On his 1980 engineering Schedule C, petitioner deducted $3,061 as travel and entertainment expenses. After concessions by respondent of $846 for airline tickets and $743.96 for lodging, $1,471.04 remains in issue. Petitioner testified that this amount was expended for various business meals and provided nine charge card receipts totaling $184.83 as his only substantiation. He also deducted

$312 in tips. Petitioner kept no log book of his business meals or tip expenses.

For any entertainment expense to be deductible, the taxpayer must substantiate such expense by adequate records (such as an account book or diary, along with documentary evidence such as receipts or paid bills) or by sufficient evidence corroborating his own statement. Sec. 274(d); secs. 1.274-5(a)(3) and (4) and (c)(2), Income Tax Regs. The requirements of section 274(d) supersede our Cohan approximation authority. Sec. 1.274-5(a), Income Tax Regs.

The charge card receipts introduced by petitioner were of little probative value. None of them stated what the charge was for. Accordingly, we cannot say that these documents are enough to satisfy the strict substantiation requirements of section 274(d). Also petitioner presented no evidence with regard to the tips. Therefore, respondent's position must be sustained.

Insurance: Of the $1,653 claimed for insurance, respondent has conceded that petitioner has substantiated the following dollar amounts: automobile insurance - $926, life insurance - $326, accident insurance - $30, and Automobile Club of Southern California dues - $30. The difference between the amount claimed on the return and the total of the substantiated items was unexplained by petitioner.

The portion of automobile insurance attributable to petitioner's business use of his cars is deductible. Snyder v. Commissioner, T.C. Memo. 1975-221; Guenther v. Commissioner, T.C.

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Memo. 1975-194. Petitioner testified that the automobile insurance policy in question covered the Volvo and the Volkswagon. Of these two cars only the Volvo was driven for business purposes. As mentioned above, petitioner was able to recall only the trips to Burlingame. Therefore, mindful that we must bear heavily against petitioner for any estimates that we make (Cohan v. Commissioner, supra), we find that he incurred business related automobile insurance expenses in the amount of $200. Based on the record before us, we must sustain respondent's disallowance of the balance of the claimed insurance deductions. Sec. 1.262-1(b), Income Tax Regs.

Schooling and Books: Petitioner's claimed deduction of $1,817 was comprised of expenses incurred for two separate and distinct educational programs.

The first program of study led to petitioner obtaining a Doctor of Institutional Management degree from Pepperdine University. Petitioner completed his final course in 1979. He had taken out a school loan from Crocker Bank in the amount of $3,500 sometime prior to 1980 to pay for his Pepperdine education. In 1980, he made a payment of about $1,200 on the loan and deducted the same amount.

In resolving this part of petitioner's schooling deduction we need not reach the issue of deductibility of his Doctoral expenses. Assuming, arguendo, that the Pepperdine courses in Institutional Management were properly deductible educational

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expenses, we would still have to disallow the deduction as being claimed in the wrong year. When a taxpayer borrows money to make an otherwise deductible payment, the deduction is not postponed until the year in which the taxpayer actually pays off the loan. Granan v. Commissioner, 55 T.C. 753, 755 (1971), and cases cited therein. We must sustain respondent's position since petitioner improperly deducted his loan payments in 1980.

The balance of petitioner's claimed schooling deduction was made up of $350 tuition for a California bar examination review course, $178 for books and approximately $300 registration fee for the bar examination. Petitioner had graduated from law school in Texas some 20 years earlier. After petitioner took the review course he received a letter from the California Bar informing him that he was ineligible to sit for the exam, and refunding $182 of his registration fee. No reason was given for this rejection.

Section 1.162-5(b)(3), Income Tax Regs., disallows the deduction of expenses "for education which is part of a program of study being pursued by [an individual] which will lead to qualifying [the individual] in a new trade or business." Petitioner's bar review course, books and registration fee led to his attempted qualification to practice law and are nondeductible under the above cited regulation. Sharon v. Commissioner, 66 T.C. 515 (1976), affd. per curiam, 591 F.2d 1273 (9th Cir. 1978). It is immaterial that petitioner was not allowed to sit for the

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exam. Cf. Glenn v. Commissioner, 62 T.C. 270, 278 (1974). Respondent's position is sustained.

Interest: In addition to the amounts conceded by respondent, peititioner testified that he paid interest in 1980 on a $1500, 7-percent loan taken out in 1974. This loan helped petitioner defray his schooling expenses while attending the University of Southern California from 1974 to 1977.

Petitioner provided no testimony or proof to show the amount of interest paid on this loan in 1980. Furthermore, we cannot approximate the interest paid under the Cohan rule since we have nothing in the record indicating whether interest was charged evenly throughout the life of the loan or whether any payments were in fact made in 1980. Petitioner has not met his burden of proof on this additional issue, and respondent's disallowance of the amounts not conceded must be sustained.

Rent (office at home) and Utilities: Petitioner deducted $750 as an office at home expense on his engineering Schedule C. Section 280A generally disallows a deduction for the business use of a dwelling unit that is used by the taxpayer as a residence. If, however, an allocable portion of the dwelling unit is used exclusively on a regular basis as the principal place of the taxpayer's business, then a deduction may be allowed. Sec. 280A(c)(1)(A).

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Petitioner testified that he used his basement exclusively as an office. His basement was furnished with a desk, filing cabinets, work tables, and drawing boards. Only petitioner was allowed to use the basement.

Petitioner offered credible testimony on this issue. We find that petitioner is entitled to an office at home deduction in the amount of $750 since the office was exclusively used as the principal place of petitioner's engineering business

Petitioner also deducted $146 in utilities expense attributable to his basement office. The amount claimed represents approximately 24-percent of petitioner's following 1980 utilities expenses: $309.86 in water and power charges, gas bills of $163.09 and cable television expenses of $135. The utilities expenses attributable to petitioner's office are properly allowable. However, petitioner has not proven that cable television is an ordinary and necessary engineering expense. Accordingly, we find that petitioner may properly claim $114 in utilities on his engineering Schedule C.

Messenger and Passport: Based on the record before the Court, we believe that $26 in messenger expenses and $15 passport fee represented ordinary and necessary business expenses and are allowable under section 162(a).

Remaining Deductions: With respect to the following items, petitioner did not persuade the Court that they represent anything but nondeductible personal expenses: Laundry and Cleaning - $85, Legal and Professional - $944, Post Office Box -

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$28, Gifts - $846, and Membership fees - $35. Sec. 262. Respondent's position must be sustained as to these claimed deductions.

TAX SERVICE ACTIVITY

Turning to petitioner's tax service activity, the underlying issue to be decided is whether such activities constituted a trade or business. Petitioner's tax service activities were in diminishing volume as each year went by. In 1978 he received a total of $510 from nine clients; in 1979 he received a total of $305 from six clients; in 1980 he received a total of $260 from three people, two of whom were friends and the remaining person was a client he had served for many years. Petitioner claimed the following expenses from this activity in 1980:

Depreciation	$ 75
Legal and Professional Services	65
Office Supplies	15
Postage	12
Rent on Business Property	248
Telephone	18
Travel and Entertainment	61
Utilities	48
Total Deductions	$542

The phrase "trade or business" is used in many sections of the Internal Revenue Code, and it does not always have the same meaning. But "[u]nder any definition, a business means a course of activities engaged in for profit." 4A Mertens, Law of Federal Income Taxation, Sec. 25.10, at 34 (1985 rev.); Industrial Research Products, Inc. v. Commissioner, 40 T.C. 578, 590 (1963). Petitioner has the burden in these circumstances of proving that

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he had an actual and honest objective of making a profit from his tax service activities. Dreicer v. Commissioner, 78 T.C. 642, 646 (1982), affd. without opinion 702 F2d 1205 (D.C. Cir. 1983). The record leaves the Court with the clear impression that for a number of years petitioner had been letting his tax service activity dwindle down, by attrition, to near extinction. At least, by 1980, petitioner no longer had an actual and honest profit objective for his tax services. The record shows no effort by the petitioner to obtain new clients or to replace former clients. By 1980 petitioner simply was not conducting this activity in a businesslike manner calculated to earn a profit.

Petitioner failed to satisfy the Court that there was any actual use of his basement office space for his alleged tax service business. Accordingly, his claimed, but unproven, office at home expenses does not militate against our conclusion that the basement office was used exclusively for his engineering business. Since we have found that the tax services did not constitute a trade or business in 1980, all claimed expenses in excess of the gross income of $260 must be disallowed. Section 183 (b).

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ADDITIONAL ISSUES

Although petitioner stated in his petition that: (1) he was not liable for the self-employment tax determined by respondent in the notice of deficiency, and (2) he was eligible to carry back to 1980 a net operating loss generated in 1983, he offered no proof on either issue at trial. Nor did petitioner offer any proof regarding the addition to tax imposed under section 6653(a). Accordingly, petitioner is deemed to have conceded these issues, or at least he has not carried his burden of proof on these issues, and respondent's position must be sustained.

To reflect the foregoing,

Decision will be entered under Rule 155.

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T. C. Memo. 1986-94

UNITED STATES TAX COURT

JOHN T. MILLS AND PRISCILLA L. MILLS, ET AL.,[1] Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 14629-81,
14630-81,
2879-82.

Filed March 10, 1986.

G. Gray Wilson, James M. Iseman, Jr., for the petitioners.

Gary F. Walker, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: In these consolidated cases, respondent determined that deficiencies in income taxes are due from petitioners as follows:

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[1] Cases of Ellis Hosiery Mills, Inc., docket No. 14630-81; and Ellis Mills and Anne D. Mills, docket No. 2879-82, were consolidated herewith for trial, briefing and opinion.

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Petitioners	Taxable Year Ended	Deficiency
John T. Mills and Priscilla L. Mills Docket No. 14629-81	12-31-76	$301,080.00
Ellis Hosiery Mills, Inc. Docket No. 14630-81	3-31-78	$ 96,000.00
Ellis Mills and Anne D. Mills Docket No. 2879-82	12-31-76	$345,149.43

After concessions, the issues remaining for decision are: (1) whether petitioner, Ellis Hosiery Mills, Inc., is entitled to deduct as a bad debt in 1978 the balance of $200,000 due on a $500,000 transfer made in 1976 by Ellis Hosiery Mills to Lake Hickory Double Knit, Inc., a related corporation; and (2) whether the transfer in 1976 constituted a constructive dividend to petitioner, John T. Mills.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations and exhibits associated therewith are incorporated herein by reference.

Petitioner, Ellis Hosiery Mills, Inc. (EHM), a North Carolina corporation, had its principal place of business in Hickory, North Carolina, at the time its petition was filed. Its Federal income tax return for the fiscal year ended March 31, 1978 was filed with the Internal Revenue Service Center, Memphis Tennessee.

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Petitioners, John T. and Priscilla L. Mills, husband and wife, resided in Hickory, North Carolina, at the time their petition was filed. Their joint income tax return for the calendar year 1976 was also filed with the Internal Revenue Service Center in Memphis.

Petitioners, Ellis and Anne D. Mills, husband and wife, also resided in Hickory when their petition was filed. They, too, filed a joint income tax return for the calendar year 1976 with the Memphis Service Center.

During the taxable years under consideration and for some time prior thereto, Ellis Mills and his son, John T. Mills, were engaged in the hosiery business, primarily through EHM and four other corporations known as Ellis Hosiery Mills Sales Company, Inc. (EHM Sales); Mills Yarn, Inc. (MY); Winchester Hosiery Mills, Inc. (WHM); and Lake Hickory Double Knit, Inc. (LHD).

Ellis Mills started the business which was later known as Ellis Hosiery Mills in 1936. He incorporated it as EHM in 1947. This corporation was primarily engaged in the manufacture of greige goods, an unfinished and undyed knitted material, used in the manufacture of hosiery. Ellis Mills was the president of EHM from its incorporation until his retirement in 1978. During the years 1972 through 1978 EHM had outstanding two classes of stock, i.e., preferred stock, all of which was owned by Ellis Mills, and common stock, all of which was owned by John T. Mills. The common stock had voting rights, but the preferred stock did not.

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On March 31, 1976, and March 31, 1977, EHM had retained earnings in the respective amounts of $1,347,107.33 and $1,425,726.56. Its taxable income was $84,648.59 for fiscal 1976 and $101,386.62 for fiscal 1977.

Ellis Hosiery Mills Sales Company was founded by Ellis Mills in 1942 and was incorporated by him as EHM Sales in 1975 under the laws of the State of New York. During the years 1972 through 1978, EHM Sales was a wholly-owned subsidiary of EHM and as sales agent marketed all products manufactured by EHM. Ellis Mills and John T. Mills were its president and vice president, respectively.

MY was incorporated by Ellis Mills in 1955 under the laws of the State of North Carolina. During 1972 through 1978 Ellis Mills was the president of MY and its outstanding stock was owned as follows:

Stockholders	Shares	Percent
Ellis Mills	259	60%
Unrelated Parties	171	40%
TOTAL	430	100%

During the years 1972 through 1978, MY was engaged in the business of texturing nylon in order to give it stretch characteristics. The textured nylon was then sold by MY primarily to EHM.

WHM was incorporated by John T. Mills in 1964 under the laws of the State of Virginia, and during 1972 through 1978 he was its president. Its outstanding stock was owned as follows:

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Stockholders	Shares	Percent
John T. Mills	550	68.75%
Ellis Mills	125	15.63%
Ellis Mills, Jr.	5	.62%
Unrelated Parties	120	15.00%
TOTAL	800	100.00%

WHM was engaged in the business of manufacturing greige goods for resale.

LHD was also a North Carolina corporation. All of its outstanding stock was acquired in 1971 by WHM. LHD remained a wholly-owned subsidiary of WHM until LHD was liquidated at the end of 1977. John T. Mills was the president of LHD throughout this period.

From about 1971 through 1978 the five corporations described above were under the complete dominion and control of Ellis Mills and John T. Mills, who together or separately were responsible for all of the corporate acts of each of the five companies. During this period each of the five corporations dealt extensively with nonrelated entities. However, during the same period the corporations carried on for the Mills family an integrated hosiery business. The integration as a form of business was adopted and used by the corporations because Ellis Mills and John T. Mills knew that to maximize profits in the hosiery business it was necessary to control the product from the raw material to the market place. In an attempt to accomplish this goal, Ellis Mills and John T. Mills anticipated that their five corporations would be utilized in such a manner as to

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control their hosiery business from the manufacture of the yarn through the knitting, dying, doubling, folding, and selling of the finished hose.

In actual operation under the integration each of the corporations provided services to and was the recipient of services from the other four corporations. For instance, beginning on February 26, 1971 and ending on January 4, 1972, EHM transferred $419,439.36 to LHD by a series of 16 separate transactions. These transfers were made so that both of the corporations involved could expand into the double-knit polyester market. Each of these transfers was represented by a demand note bearing interest from four percent to six percent and all of the notes were repaid with interest by February 28, 1973. Again, on June 29, 1973, EHM advanced $8,000 to LHD. This advance was also represented by a demand note bearing interest at six percent and was repaid with interest by September 30, 1974. During 1974 and 1975 LHD provided factoring services to EHM for approximately $700,000 worth of business with W. T. Grant Company, the largest customer of EHM. During 1975 and 1976 EHM Sales provided sales, logo, and advertising services to LHD for its double-knit business.

In addition to the sums advanced by EHM, LHD arranged several other loans from independent financial institutions. The schedule below reflects the year, amount, interest rate, and security applicable to such loans:

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Fiscal Year Ended	Amount	Interest	Security
9-30-71	-0-	-0-	---
9-30-72	$ 42,371.64	8%	Equipment
	$116,359.56	8%	Equipment
9-30-73	$ 71,645.00	Prime rate plus 3%	Equipment
9-30-74	$ 24,500.00	Prime rate plus 3%	Equipment
9-30-75	$ 25,419.60	12%	Equipment
	$ 17,887.93	12%	Equipment
9-30-76	-0-	-0-	---
9-30-77	$ 1,121.18	9%	EHM Stock
	$ 1,556.11	12%	Equipment
	$ 18,347.64	10.5%	Equipment and Real Estate

LHD's venture into the double-knit business did not prosper. By 1976, the industry was bottoming out and LHD reported a loss for the fiscal year of $134,620.77 and on September 30, 1976, LHD owed MY $525,775.56 for raw materials. To allay the anxiety which this large unpaid account aroused among MY's minority shareholders and to maintain harmony in its integrated business, EHM agreed to transfer $500,000 to LHD so that the account could be paid. The transfer was made by EHM to LHD on September 30, 1976. It was not represented by a promissory note or any other evidence of an unconditional promise to repay the sum advanced. With the transferred funds, LHD paid the MY account and MY in turn repaid $500,000 of the funds which it had previously borrowed from EHM. The accounting records of the three companies reflect (1) that on September 30, 1976 the $500,000 was advanced by EHM to LHD as a loan, (2) that on the same date LHD paid the

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$500,000 on the account payable which it had it with MY, and (3) that on the same date MY paid the $500,000 on its loan payable to EHM. As a result, the $500,000 passed on the same day from EHM to LHD, from LHD to MY, and from MY back to EHM.

Late in 1977 Ellis Mills and John T. Mills decided to enter the girls' knee-high hosiery business through the use of EHM, to transfer sufficient personnel to support this line of hosiery from LHD to EHM, and to completely liquidate LHD as of December 31, 1977. In accordance with this decision LHD's assets were transferred to WHM in exchange for the assumption by WHM of all of LHD's liabilities with the exception of the balance of $475,000[2] which was then due on the $500,000 "indebtedness" to EHM. WHM agreed to assume and pay only $275,000 in full settlement of this account. However, all other debts of LHD to nonrelated creditors were fully satisfied by WHM, leaving outstanding only the $200,000 due EHM which EHM deducted as a bad debt on its income tax return for the year ended on March 31, 1978.

Respondent disallowed the bad debt deduction claimed by EHM and determined that the transfer was, in reality, a constructive dividend in 1976 to John T. Mills or, in the alternative, a constructive dividend in 1976 to Ellis Mills. However, on brief respondent has conceded that the transfer was not a constructive dividend to Ellis Mills.

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2 LHD had previously paid $10,000 to EHM in March 1977, and $15,000 in June 1977, which had been applied to the $500,000 transfer leaving the $475,000 balance.

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OPINION

Respondent contends that EHM is not entitled to a bad debt deduction under section 166 because the original transfer of the $500,000 from EHM to LHD did not constitute a bona fide loan but instead was a constructive dividend from EHM to John T. Mills, the owner of all of its common stock, and a contribution by him to the capital of LHD, the wholly owned subsidiary of WHM, another corporation which was controlled by John T. Mills through his ownership of nearly 69 percent of its stock and another 16 percent of the stock which was owned by his father and his brother. Petitioners insist that the transfer was a bona fide loan and did not constitute a dividend.

It is well established that a transfer between related corporations can constitute a constructive dividend to the common shareholder if the transfer was made primarily for his benefit and if it results in a direct or tangible benefit to him. Gilbert v. Commissioner, 74 T.C. 60 (1980); Schwartz v. Commissioner, 69 T.C. 877 (1978); Rapid Electric Company v. Commissioner, 61 T.C. 232 (1973). On the other hand, if the disputed transfer constitutes a bona fide loan or if the benefit to the common shareholder is only indirect or derivative in nature there is no dividend. Gilbert v. Commissioner, supra. Whether the transfer is a bona fide loan and the nature of the benefit to the common shareholder are factual issues which must be determined from a consideration of all of the circumstances and with the burden of proof being upon petitioners. Gilbert v. Commissioner, supra; Schwartz v. Commissioner, supra.

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The key question in determining whether or not there was a bona fide loan is whether the parties to the transfer had a genuine intention to create a debt. Furthermore, the resolution of the key question must be determined by weighing objective factors such as the economic reality of the claimed relationship and the presence or absence of a reasonable expectation of repayment of the purported debt. The stated intention of the parties is not sufficient unless supported by objective factors indicating that the transaction had economic reality. Gilbert v. Commissioner, supra; Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973); Alterman Foods, Inc. v. United States, 505 F.2d 873, 879 (5th Cir. 1974).

We find that petitioners' arguments in these cases that the transfer constituted a bona fide loan are not persuasive for the following reasons:

(1) The testimony of John T. Mills and Ellis Mills as the principal officers and controlling stockholders of EHM, the transferor of the funds, and LHD, the transferee, to the effect that the transfer was intended by both parties as a loan is not sufficient because such testimony is not supported by the objective factors present in these cases. First, at the time the transfer was made and for several years prior thereto John T. Mills and his father Ellis Mills had admittedly controlled, managed, and operated all five of the family corporations as a single integrated hosiery business with the idea of controlling the manufacture and sale of their product. Consequently, because of the rigid family control any transaction between two of the

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corporations is subject to scrutiny. Secondly, the transaction involved in this case does not have any of the usual characteristics of a loan. It was not represented by a promissory note. There was no provision made for the payment of interest or of a schedule for the repayment of the principal. All of these contemporaneous factors tend to establish that there was no unconditional obligation by LHD to repay the amount advanced and such factors are entitled to more weight than the testimony of the parties as to their intent.[3] Road Materials, Inc. v. Commissioner, 407 F.2d 1121, 1124 (4th Cir. 1969); Gilbert v. Commissioner, 74 T.C. at 65.

(2) Petitioners' contention that the intent to treat the transfer as a loan is clearly reflected by the manner in which EHM and LHD handled the transaction on their accounting records is not convincing because "consistent bookkeeping and consistent financial reporting on balance sheets are * * * little more than additional declarations of intent, without any accompanying objective economic indicia of debt." Alterman Foods, Inc. v. United States, supra at 879. See also Dean v. Commissioner, 57 T.C. 32, 44 (1971).

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[3] In the past we have sometimes minimized the importance of the absence of a promissory note or other formal instrument of debt or even the absence of interest. See Joseph Lupowitz Sons, Inc. v. Commissioner, 497 F.2d 862, 868 (3rd Cir. 1974), affg. on this issue a Memorandum Opinion of this Court. We believe, however, that the absence of such factors in this case is important because they are inconsistent with the manner in which loans between the related corporations had been handled in the past and especially with the manner in which loans had been handled by the corporations with outside institutions.

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(3) Under all of the circumstances involved in this particular case we are not convinced that even a partial repayment of $300,000 is indicative that the original $500,000 transaction was a genuine debt. This is true because in the 15 months prior to the liquidation of LHD only $25,000 had been paid to EHM. Furthermore, any favorable inference which might be drawn from the repayment of the additional $275,000 upon the liquidation of LHD is considerably diminished by the fact that it was generated by another transaction between related companies which at best is subject to close scrutiny because the purchaser agreed to pay all the other creditors in full while paying EHM only $275,000 on an alleged debt totaling $475,000. Under these circumstances we are unable to agree with petitioners that the $275,000 transaction between WHM and EHM had any bearing whatsoever on the genuineness of the debt which was allegedly created between LHD and EHM 15 months previously.

(4) From the record before us we are unable to conclude that EHM, the alleged lender of the $500,000, had any corporate business purpose for making the transfer to LHD. The presence or absence of such a purpose by the corporate transferor is another factor to be considered. Gilbert v. Commissioner, supra at 67. In fact, from the record as a whole, it is apparent that the transfer was made because LHD (a corporation indirectly owned and controlled by John T. Mills through WHM) was so undercapitalized that it could not satisfy an account payable to MY (a corporation controlled by Ellis Mills through his 60 percent of its stock) and whose minority shareholders were upset and disturbed by the

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unpaid account. The transfer permitted LHD to make a $500,000 payment on the account and MY used the same funds on the same date to pay $500,000 which it owed to EHM. The end result to EHM was an exchange of a receivable from MY for an equal receivable from LHD. We are at a loss to see how the exchange served any corporate purpose for EHM. Gilbert v. Commissioner, supra at 66-67.

(5) We are also unable to agree with petitioners' contention that John T. Mills did not realize any benefit from the transfer of funds. To the contrary, the record as a whole clearly establishes that John T. Mills was able to use monies belonging to EHM (a corporation controlled by him) to provide funds to LHD, an uncapitalized wholly-owned subsidiary of WHM (another corporation controlled by him), which monies LHD immediately used to make a substantial payment on an account payable to MY, a corporation controlled by the father of John T. Mills, but whose minority shareholders were disturbed by the unpaid account to the point where it constituted a threat to the operation of the family's integrated hosiery business. As part of the same transaction, MY used the funds to repay a loan payable to EHM. By means of this scheme, John T. Mills managed to at least temporarily overcome the capitalization problems of LHD without making any capital contribution either directly to LHD or indirectly through its parent, WHM. Furthermore he accomplished it without incurring any personal interest expense, encumbering any personal capital, or reducing his personal credit. The result was an obvious, direct benefit to John T.

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Mills and to his family's integrated hosiery business. Just as obviously as pointed out previously it served no corporate business purpose for EHM.

In view of all of the foregoing, we conclude that the transfer in 1976 of the $500,000 from EHM to LHD did not constitute a bona fide loan, but instead was a constructive dividend from EHM to John T. Mills. Consequently, EHM is not entitled to a bad debt deduction in 1978.

Decisions will be entered under Rule 155 in Docket No. 14629-81 and Docket No. 14630-81.

Decision will be entered for petitioner in Docket No. 2879-82.

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T. C. Memo. 1986-95

UNITED STATES TAX COURT

FIRST NATIONAL BANK OF BERESFORD, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 34434-84. Filed March 10, 1986.

Danny R. Smeins and Frank L. Farrar, for the petitioner.

James C. Lanning, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GERBER, Judge: Respondent has moved for the dismissal of this case due to lack of jurisdiction premised upon the ground that a petition was not filed within 90 days of mailing of the statutory notice of deficiency as required in section 6213(a).[1] Petitioner admits that its petition was filed 297 days after the notice was mailed, but counters that respondent did not send the notice to its "last known address" as required in section 6212.

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect for the time in question.

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Although the notice was addressed to the address shown on petitioner's return, petitioner contends that respondent was aware and/or advised to send the notice to petitioner's representatives.

During the period in question, Frank L. Farrar (Farrar) "owned" but was not an officer of, the First National Bank of Beresford, Beresford, South Dakota (petitioner), and he was also an attorney familiar with tax matters and admitted to practice before this Court. During the course of the audit, respondent's agents contacted Farrar in his Britton, South Dakota, law office, which was 225 miles from petitioner's place of business. For example, when the agent wished to extend the statute of limitations on assessment, he would go to Farrar's office in Britton (rather than petitioner's location--Beresford, South Dakota) and Farrar would arrange to have the document executed on petitioner's behalf.[2] Farrar did not have a power of attorney regarding petitioner. The actual review of the books and records was accomplished at petitioner's place of business in Beresford. Additionally, petitioner engaged Peat, Marwick, Mitchell & Co. (Peat, Marwick) as its auditor. Peat, Marwick was located in Des Moines, Iowa, and was given a power of attorney for 1977, 1978 and 1979. The power of attorney designated a Peat, Marwick employee as an addressee for "copies of notices and other written

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[2] Although Mr. Farrar testified that all transactions and correspondence with respondent occurred or were received in his office in Britton, S.D., the documents in the record were all addressed to petitioner at Beresford, S.D.

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communications * * *." At the conclusion of the examination, Farrar stated "that [he advised respondent's agent that petitioner] would not accept the case, and to go ahead and send the Statutory Notices to me, and [the agent] said he would do that, and [Farrar] never heard [from respondent]." Farrar also stated that the statutory notice in question was never received by Farrar or Peat, Marwick and that petitioner may have been sent a notice, but there is no current record or evidence that it was received by petitioner. Petitioner was first aware of the possibility that a notice may have been issued when it received tax bills for the years in question reflecting that the deficiencies had been assessed.[3] Farrar wrote to respondent several times after petitioner received the tax bills, but has not yet received a copy of the notice in this case.

Respondent's agent sent the examination report (so-called 30-day letter) to petitioner at Beresford, South Dakota, and the transmittal letter advised that the report concerned taxable years in addition to those set forth in the power of attorney (presumably the one concerning Peat, Marwick) and that no copy could be sent to petitioner's representative. Respondent's agent asserted that "no one suggested to [him] that notices * * * be sent to any address other than that of the [petitioner's] place of business in Beresford, South Dakota * * *."

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[3] We find it rather curious that the statutory notice which is the focal point of this motion to dismiss has not been made a part of the record in this case although there is evidence of its mailing and acknowledgment by petitioner that it was sent or mailed.

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The pivotal question is whether an oral statement to direct the notice to a different address (from that shown on the return) by one who does not possess a power of attorney or who is not an officer of petitioner, would affect the "last known address" within the meaning of section 6212. Recognizing that there is a direct conflict in the evidence, we assume for purposes of this discussion that Farrar requested that respondent's agent forward the notice to him.

Failure of respondent to send a copy of a notice to petitioner's representative who, under a power of attorney, was entitled to copies is of no effect. In this instance, respondent may have been justified in failing to send petitioner's representative a copy of the notice because the power of attorney was for three taxable years and the subject notice pertained to more than those three taxable years. See sec. 6103; Allen v. Commissioner, 29 T.C. 113, 116, 117 (1957); McDonald v. Commissioner, 76 T.C. 750, 752, 753 (1981). The power of attorney in this case reflected petitioner's address in Beresford, South Dakota, and not at Farrar's address in Britton, South Dakota. The power of attorney was signed by Robert Knapke, president of petitioner. All correspondence from Farrar to respondent's agents reflected an "in re" showing petitioner's address in Beresford, South Dakota. Assuming that Farrar told respondent's agent to "send the Statutory Notices to me," that is not sufficient "notice" to change petitioner's "last known address" within the meaning of section 6212 under the

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circumstance of this case. Houghton v. Commissioner, 48 T.C. 656, 661 (1967). The overwhelming weight of evidence in this case reflects that respondent, petitioner and petitioner's representative (Peat, Marwick) had consistently treated Beresford as petitioner's address. All correspondence and the power of attorney support that conclusion. Farrar's request to "send the * * * notices to me," does not necessarily change the address, since Farrar was the "owner" of petitioner and could ostensibly receive mail at the bank he owned. Further, and more significantly, Farrar was not a legal representative or agent of petitioner and clearly did not have the authority to act on behalf of petitioner. Indeed, when it was necessary to sign a consent to extend a statute of limitations on assessment, it was necessary to forward it to petitioner's president, Robert Knapke, for execution. Moreover, Farrar, an experienced tax lawyer and representative of clients before the Internal Revenue Service, could be expected to recognize the need for a written or more formal method of changing a "last known address" within the meaning of section 6212. We accordingly hold that respondent has met the statutory requirement of mailing a statutory notice to petitioner's "last known address" and that the petition is untimely so as to justify the dismissal of this case for lack of jurisdiction.

An appropriate order will be entered.

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T. C. Memo. 1986-96

UNITED STATES TAX COURT

ELDON J. WEST and VERA F. WEST, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 13330-81. Filed March 10, 1986.

Ray O. Womack, for the petitioners.

Irene Scott Carroll, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FAY, Judge: Respondent determined deficiencies in and additions to petitioners' Federal income tax as follows:

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Year	Deficiency	Additions to Tax Sec. 6651(a)(1)[1]	Sec. 6653(a)
1975	$1,661	$ 415	$ 97
1976	4,770	1,193	560
1977	7,255	1,088	363

After concessions by the parties, the sole issue is whether petitioners are entitled to deduct amounts expended by them in connection with activities related to a certain soil treatment process.

FINDINGS OF FACT

Some of the facts are stipulated and are found accordingly. Petitioners, Eldon J. West (herein, "petitioner") and Vera F. West, are husband and wife and resided in Corona, Calif., when they filed the petition herein.

Petitioner was a real estate broker during 1975, 1976, and 1977. In the early part of 1976, petitioner met Lester Lemm (herein "Lemm") and Gary Baker (herein "Baker") who invited petitioner to participate in the exploitation of a soil treatment process which Lemm claimed to have invented. Lemm and Baker represented to petitioner that such process destroyed nematodes with the use of seismic equipment and without the need for

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

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chemicals.[2] Lemm and Baker produced a letter from an environmental biologist Robert L. Pope (herein "Pope") which stated that initial tests showed such soil treatment process to produce "effective nematode control". Lemm and Baker asked petitioner to provide funding for the promotion of such activities and for the purchase of necessary equipment.

On April 20, 1976, petitioner, Lemm, and Baker executed a document entitled "joint venture agreement" (herein "agreement") wherein petitioner agreed to contribute $15,000, consisting of $5,000 for expenses incurred for the promotion of activities and $10,000 as a down payment for the necessary equipment, and his time and skill in promoting the activities. Lemm and Baker each agreed to contribute his time and skill as a technical expert and scientist to promote the marketing of the soil treatment process. No monetary contribution was required of Lemm or Baker. In sum, petitioner was to finance the entire operation.

Pursuant to the agreement, petitioner was to hold legal title to the property to be purchased as trustee for himself, Lemm and Baker. Petitioner, Lemm, and Baker would each own an undivided one-third beneficial interest in such property. Profits from the soil treatment activity would be divided equally among petitioner, Lemm, and Baker. There was no mention in the agreement as to how losses were to be divided.

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Nematodes are parasitic worms which are harmful to animals and vegetation.

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After executing the agreement, petitioner expended additional funds to advertise such soil treatment process and attempted without success to solicit clients. Petitioner also purchased five mobile seismic units commonly used for oil explorations which, Lemm represented, would send shock waves through the soil and thereby eliminate nematodes. Each unit weighed 29,600 pounds, was approximately twenty feet long and eight feet wide and was transported by being hung on hydraulic cables in the center of a truck. Petitioner purchased a truck and a trailer to transport such units to California from Texas where they were purchased. Prior to the purchase of the mobile seismic units, petitioner also rented a similar unit from a lessor in Texas and paid for the transportation of it to Idaho where petitioner arranged for tests to be conducted. Petitioner later conducted tests using the purchased units.

The reports petitioner received regarding the tests conducted using the seismic equipment were inconsistent. Pope continued to report that such method was successful in eliminating nematodes while others questioned the reliability of the testing procedures implemented and reported that the soil treatment process was ineffective. In May 1977, becoming very suspicious, petitioner finally obtained an independent examination of the soil treatment process by the Department of Nematology at the University of California at Riverside,

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California at the expense of $1,500. Petitioner was informed that the seismic equipment was not effective in eliminating nematodes.

The only role Lemm and Baker had with respect to the soil treatment process activity was periodically meeting with petitioner to conduct tests and accepting payments from petitioner. Sometime in 1977, without petitioner's knowledge, Baker sold the seismic equipment purchased by petitioner. Thereafter, Lemm and Baker relocated and petitioner had no knowledge of their whereabouts. Petitioner eventually sold the truck and trailer which he originally purchased to transport the seismic units.

During the taxable years in issue, no business records, other than the register from petitioner's personal checking accounts, were maintained with respect to the activities relating to the soil treatment process. In 1976 and 1977, petitioner expended a total of $42,121.23 in connection with such soil treatment activities as evidenced by copies of cashier's checks and a personal money order as well as the check book register of petitioner's personal checking account; all of these documents have been stipulated to by the parties. Of this amount, $35,280.46 was expended in 1976 and the remaining $6,840.77 was expended in 1977. With the exception of $10,240, which petitioner paid to Lemm and Baker, petitioner had complete control with respect to how such funds were to be spent.

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On their 1977 joint Federal income tax return, petitioners deducted as a casualty or theft loss $43,576, representing expenses relating to the soil treatment process.[3] In his notice of deficiency, respondent disallowed such deduction for 1977 and made other adjustments unrelated to the soil treatment process with respect to petitioners' Federal income tax for 1975, 1976 and 1977. Petitioners now concede on brief that the expenses pertaining to the soil treatment process were improperly deducted as a casualty and theft loss but argue that such expenses are nonetheless deductible under sections 162, 212 or 1231.[4] The parties are in agreement with respect to all other items set forth in the notice of deficiency, including the additions to tax.

OPINION

The sole remaining issue is whether petitioners are entitled to deduct the amounts expended by them in connection with the soil treatment process.

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Petitioners claimed the loss in the amount of $43,676 but deducted only $43,576 (i.e., that portion in excess of $100) on their return pursuant to sec. 165(c). On brief, petitioners assert that they expended $51,639.74 in connection with the soil treatment activity. From the record, we find that $42,121.23 was expended.

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For reasons not apparent, petitioners conceded the issue of whether the amount they expended in connection with the soil treatment process constitutes a casualty and theft loss. We do not consider such issue here as it is not properly before us.

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Petitioners argue that petitioner conducted the activities at issue in his individual capacity and that the expenses at issue are deductible under either section 162 or section 212. Finally, they argue that such expenses constitute losses deductible by reason of section 1231.

Respondent's determination is presumed to be correct and petitioners have the burden of proving it to be otherwise. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

We first examine petitioner's contention that the activities should be viewed as being conducted in his individual capacity rather than as a partner or a joint venturer. While all the facts and circumstances are to be examined in determining if persons have formed a joint venture or partnership, the essential question is whether the parties intended to, and did in fact, join together for the present conduct of an undertaking or enterprise. Luna v. Commissioner, 42 T.C. 1067, 1077 (1964), citing Commissioner v. Culbertson, 337 U.S. 733 (1949). The parties' intention is a question of fact, to be determined from testimony disclosed by the agreement and by the parties' conduct in execution of the provisions of such agreement. Commissioner v. Culbertson, supra. The record reveals that it was petitioner who supplied the funds and exerted the effort to purchase and rent the necessary equipment. Petitioner alone solicited accounts and clients for such activities. From the record, we are convinced that Lemm and Baker did not intend to perform under

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the agreement. They did no more than make an apperance at the tests and accepted payments from petitioner. From the record, we find that no joint venture or partnership was formed.

Having determined that petitioner engaged in such activities in his individual capacity, we now consider if the expenses at issue are deductible. Petitioners first argue that the expenses at issue are deductible under section 162.

Generally, under section 162, a taxpayer may deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business. Sec. 162(a). To determine whether activities constitute carrying on a trade or business, this Court has held that all the facts in each case must be examined. Groetzinger v. Commissioner, 82 T.C. 793, 796 (1984), affd. 771 F.2d 269 (7th Cir. 1985). Although the record indicates that petitioner expended a degree of personal effort as well as money with respect to the soil treatment process, we find petitioner's activities not sufficiently regular, frequent, active and substantial to constitute a trade or business. See Groetzinger v. Commissioner, supra. We therefore hold that the expenses at issue are not deductible under section 162.

In the alternative, petitioners argue that the amount expended is deductible under section 212. Such section allows a deduction for all the ordinary and necessary expenses paid or incurred (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the

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determination, collection, or refund of any tax. Section 212 was designed to allow deductions for certain nontrade or nonbusiness expenses. Lykes v. United States, 343 U.S. 118 (1952). The deductibility of such losses depends upon the taxpayer's proven intention to realize a profit through such activities. Bessenyey v. Commissioner, 45 T.C. 261 (1965), affd. 379 F.2d 252 (2d Cir. 1967), cert. denied, 389 U.S. 931 (1967); see also sec. 183(a). It is not crucial that the taxpayer's expectation be a reasonable one; it is enough that the taxpayer have a bona fide objective of realizing a profit. Bessenyey v. Commissioner, supra; sec. 1.183-2, Income Tax Regs. That there is a small chance of making a large profit may be sufficient to show that a profit-making objective exists. Sec. 1.183-2(a), Income Tax Regs. All the facts and circumstances with respect to such activities are to be taken into account. Sec. 1.212-1(c), Income Tax Regs., 1.183-2, Income Tax Regs. The record indicates that petitioner expended substantial sums of money and effort in the implementing of the soil treatment process. Petitioner's credible testimony at trial recounting his initial belief that such soil treatment process would allow him to realize a fortune is supported by his diligence in implementing such process. Considering the record in its entirety, we hold that petitioner engaged in the activities involving the soil treatment process with an objective of making a profit such that deductions under section 212 may be allowed.

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To be deductible under section 212, expenses must be ordinary and necessary to the income producing activity. Sec. 212; sec. 1.212-1(d), Income Tax Regs. While we are persuaded that some of the expenses incurred by petitioners satisfy the ordinary and necessary standard and are thus properly deductible under section 212, we hold that part of the amount petitioner paid to Lemm and Baker is not deductible. From the record, during the years in issue, petitioner paid Lemm and Baker a total of $10,240. Of this amount, we find that $5,000, which petitioner is required to pay pursuant to the agreement, is properly deductible under section 212. However, the record is silent as to the purpose for the payment of the remaining $5,240 to Lemm and Baker and we therefore hold that such amount is not properly deductible under section 212.

Petitioners also argue that the entire amount expended constitutes a loss deductible by reason of section 1231. As we have found that some of the expenses at issue are deductible under section 212, we limit our discussion of section 1231 to the remaining amount which petitioner paid to Lemm and Baker, i.e., the amount we found thus far not to be deductible. Section 1231 relates to the recognized gains and losses arising from the sale or exchange of property used in the trade or business. Sec. 1231; Sec. 1.1231-1(c)(1), Income Tax Regs. Section 1231 also applies to recognized gains and losses from the compulsory or involuntary conversion of property used in the trade or business and of certain capital assets. Sec. 1231; Sec. 1.1231-1(c)(2),

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Income Tax Regs. From the record, petitioners have failed to prove that such amounts constitute losses to which section 1231 applies. Therefore, we hold that section 1231 is not applicable herein.

To reflect the foregoing,

Decision will be entered under Rule 155.

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T. C. Memo. 1986-97

UNITED STATES TAX COURT

PETER AND CAROLE A. GROSEWALD, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 30702-84. Filed March, 13, 1986.

Peter Grosewald, pro se.

Joyce Bauchner, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARR, Judge: Respondent determined a deficiency in petitioners' income tax for 1981 in the amount of $164 and an addition to tax under section 4973[1] in the amount of $27 as an excise tax authorized by that section. The sole issues for decision are whether petitioners may deduct $450 under section

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1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

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219 of the Code for a contribution to an individual retirement account (IRA), and whether the amount contributed is subject to excise tax under section 4973.

FINDINGS OF FACT

Petitioners Peter and Carole A. Grosewald filed a joint Federal income tax return for the taxable year 1981 with the Internal Revenue Service Center at Holtsville, N.Y. Petitioners resided in Putnam Valley, N. Y., at the time the petition in this case was filed.

From January 1, 1981 through April of 1981, Carole Grosewald was employed by Hudson Guild, Inc. (Hudson) and not covered by a retirement plan while employed there. For the remainder of 1981 Carole was employed by the Putnam Valley Central School District. She was an active participant in its pension plan (the "Plan"). The Plan was a qualified retirement plan established by a state or political subdivision of a state for its employess.

While employed at Hudson, Carole contributed $450 to an IRA for the taxable year 1981. The $450 contribution is less than 15 percent of Carole's salary from Hudson, and Carole made no 1981 contributions to an IRA after she terminated employment there. On petitioners' 1981 Federal income tax return they claimed a deduction for Carole's $450 IRA contribution. On June 1, 1984, respondent issued a statutory notice of deficiency disallowing this deduction and determining a 6 percent excise tax pursuant to section 4973.

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OPINION

Section 219, as applicable for 1981, allows a deduction of up to $1,500 per taxable year for a contribution to an IRA as described in section 408(a). Nevertheless, section 219(b)(2)(A)(iv) provides that no deduction for a contribution to an IRA will be allowable for a taxable year for any individual, if, for any part of the tax year, he or she was an active participant in a plan established for its employees by a state or political division thereof or an agency or instrumentality thereof. A person is considered an active participant even though he may have forfeited all of his plan benefits prior to his becoming vested. Hildebrand v. Commissioner, 683 F.2d 57, 58-59 (3d Cir. 1982), affg. a Memorandum Opinion of this Court.

In this case, Carole falls squarely within the aforementioned statutory language. Petitioners contend, however, that they are not provided with the double tax benefit the statute seeks to prevent because they made an effort to prorate their IRA contribution so that, even taking into account the Plan contributions, they would not exceed the statutory contribution limits.

Petitioners' argument is novel but must be rejected. Numerous cases have held that although the results to petitioners seem harsh, we cannot ignore the plain language of the statute, and, in effect, rewrite the statute to achieve what would appear

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to be an equitable result. E.g., Eanes v. Commissioner, 85 T.C. 168, 171 (1985); Anthes v. Commissioner, 81 T.C. 1, 7 (1983), affd. by unpublished order (1st Cir., June 26, 1984).

Petitioners have made a commendable effort to distinguish the binding precedent in the circuit to which their case is appealable. They argue that the taxpayer in Orzechowski v. Commissioner, 69 T.C. 750 (1978), affd. 592 F.2d 677 (2d Cir. 1979), contributed the maximum amount allowed under the statute for a year during which he was a member of a qualified plan for the entire year. Judged as of the end of the taxable year, the taxpayer not only had received the potential for a double benefit, but could be said to be assured of a double benefit as long as circumstances did not change. Thus, according to petitioners, Orzechowski presented the strongest case for a literal application of section 219(b)(2)(A) short of a taxpayer actually receiving a double benefit.

That Mr. Orzechowski's circumstances did change so that he did not receive a double benefit (the following year he forfeited all rights to plan benefits) is not the only thing which shows that Orzechowski is more similar to this case than petitioners acknowledge. More telling regarding the material similarity is that Orzechowski was not decided on the basis of the amount the taxpayer there contributed, but on the basis that the IRA contribution was made during a year in which the taxpayer was an

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active participant in a qualified plan. We hold that the deductions claimed in this case are not materially different from those disallowed in Orzechowski, supra.

We have considered Foulkes v. Commissioner, 638 F.2d 1105 (7th Cir. 1981), and determine it to be distinguishable from the case before us. The Foulkes decision turned on the fact that there was no potential for any double tax benefit to the taxpayer. The Foulkes court reasoned that since the taxpayer had, in the middle of the year, left the employ of the firm that maintained the qualified plan, and could not avail himself of the benefits provided by the plan, there was no potential for a double tax benefit. The crucial finding was that pursuant to the terms of the plan in Foulkes, the taxpayer forfeited his rights to benefits when he terminated his employment in the middle of the year for which he claimed an IRA contribution deduction.

In the case before us, there is no evidence that the benefits of the school district plan will not inure to Carole. Petitioners bear the burden of proving that fact, if they wish to rely on Foulkes. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure. Therefore, even if this Court adhered to the rule in the Foulkes case (but see Eanes v. Commissioner, supra), petitioners would not prevail. Moreover, to the extent that both Foulkes and Orzechowski are applicable to petitioner's situation, we would look not to the Seventh Circuit's decision in Foulkes, but to the Second Circuit's decision in Orzechowski for the applicable precedent,

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since that is the circuit to which this case would be appealed. See Golsen v. Commissioner, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir.), cert. denied 404 U.S. 940 (1971).[2]

We sympathize with the inequity of which petitioners complain by stating that they have not taken any greater monetary benefit than the statute allows. However, section 219(b)(2) was enacted to prevent not merely the actual but the potential double tax benefit which would be obtained by an individual who is a participant both in a qualified pension plan as well as an individual retirement account. Foulkes, supra, 639 F.2d at 1107. The short answer to petitioner's equity argument as we noted in a somewhat different context, is that "[t]he statute does not turn upon such considerations." Chapman v. Commissioner, 77 T.C. 477, 480 (1981).[3]

We also hold that under the clear language of section 4973 the addition to tax of $27 is warranted. Section 4973 provides that the excess of the amount contributed to an IRA over the amount deductible under section 219 shall be subject to a 6 percent excise tax. Since we have determined above that none of the $450 contributed to the individual retirement account by

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We note that the Foulkes opinion recognized that its holding would not affect facts similar to those at bar. See Foulkes v. Commissioner, 638 F.2d 1105, 1107 n. 10 (7th Cir. 1981).

3

Sec. 219 has been amended to allow persons covered by qualified plans to take deductions for contributions to IRAs in taxable years beginning after December 31, 1981. See sec. 311(a), Economic Recovery Act of 1981, Pub. L. 97-34, 95 Stat. 274. This change was not made retroactive.

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Carole is deductible under section 219, the entire amount contributed is subject to the 6 percent tax of section 4973. See Eanes v. Commissioner, supra; Orzechowski v. Commissioner, supra.

Decision will be entered for Respondent.

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UNITED STATES TAX COURT

FRANK DIAZ AND AMPARO R. DIAZ, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 1931-83. Filed March 13, 1986.

Jorge Rodriguez-Chomat, for the petitioners.

Paul M. Naponick and Kenneth A. Hochman, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

JACOBS, Judge: Respondent determined deficiencies in petitioners' Federal income taxes and additions to tax as follows:

Tax Year	Deficiency	Sec. 6653(a)[1]
1978	$7,845	$826
1979	-	137

[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the tax years in issue.

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This controversy concerns the amount of petitioner-husband's basis in the stock of United Atlantic Investment, Inc. on the date he sold it in 1978. Petitioner-husband claims that his basis in the stock was $25,000; whereas, respondent contends that the basis was $500. Respondent also asserts that petitioners are liable for an addition to tax for an underpayment of income tax due to negligence or intentional disregard of the rules and regulations for 1978.[2]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated by this reference.

Frank and Amparo R. Diaz, husband and wife, resided in Coral Gables, Florida, at the time they filed the petition in this case. Amparo R. Diaz is a party solely by virtue of having filed a joint return with her husband for 1978 and 1979. Hereinafter Frank Diaz will be referred to as petitioner.

Petitioner is an accountant, conducting his accounting practice under the name Diaz and Associates. He was also the sole stockholder and president of United Atlantic Investment,

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2 Petitioners previously agreed to certain adjustments for 1978 and 1979 and there is no dispute as to the additions to tax with respect to these adjustments.

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Inc. (UAI), a Florida corporation, from June 2, 1975, the date of its incorporation, until May 8, 1978, the date on which he sold all of his stock in UAI.

UAI's initial capitalization was $500. Over the years, petitioner lent UAI approximately one hundred and twenty thousand dollars ($120,000).

UAI reports its income on a fiscal year ending June 30. UAI's books and records are maintained by Diaz and Associates which also prepares UAI's tax returns. In reviewing UAI's tax return for the year ended June 30, 1977, petitioner observed that UAI's stated capital was $500. In January, 1978, he sent a written note to Raquel Rodriquez, an employee of Diaz and Associates and his sister-in-law, directing her to instruct the accountant in charge of the UAI account to reclassify $24,500 from the "loans from stockholder" account to the "capital stock" account.

During February or March, 1978, UAI distributed $100,000 to petitioner, leaving UAI with less than $25,000 in tangible assets. On May 8, 1978, petitioner sold all his UAI stock for $125,000.

Petitioners reported $100,000 as the gain realized from the stock sale; the gain reflected an adjusted basis of $25,000 in the UAI stock. Respondent contends that petitioner's basis in the UAI stock was $500; therefore, respondent alleges that petitioners' gain was $124,500.

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ULTIMATE FINDINGS OF FACT

Petitioner's basis in the UAI stock was $25,000.

OPINION

This case hinges on whether there was a transfer of $24,500 from UAI's "loans from stockholder" account to the "capital stock" account prior to petitioner's sale of his UAI stock in May, 1978.

Section 1012 provides that the basis of property shall be its cost. When incorporating a business, a stockholder has the prerogative, within constraints not relevant here, to denominate the amounts he advances to the corporation as either debt or equity, or some combination thereof. Rowan v. United States, 219 F.2d 51, 54 (5th Cir. 1955). In general, any subsequent transfer from debt to equity on the corporation's books increases the stockholder's basis in his stock. Sec. 1016(a)(1).

We find that the transfer of funds from the loan account to the capital account occurred prior to the time petitioner sold his stock on May 8, 1978.

The burden of proving that the transfer occurred prior to the sale is on petitioners. Rule 142(a). We found the testimony of petitioner and Raquel Rodriquez to be entirely credible and convincing. We believe that petitioner instructed the accountant in charge of UAI's books and records to reclassify $24,500 from

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debt to equity in January, 1978, and that these charges were made in compliance with petitioner's wishes prior to the sale of his stock in May, 1978.

Accordingly, we hold that petitioner's basis in the stock sold on May 8, 1978 was $25,000 and that the realized gain on the sale was $100,000.

To reflect the previously agreed adjustments,

Decision will be entered under Rule 155.

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UNITED STATES TAX COURT

THOMAS J. RODECK AND JUDY A. RODECK, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 7781-84. Filed March 13, 1986.

Thomas J. Rodeck and Judy A. Rodeck, pro se.

Rosabel I. Seigan, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GERBER, Judge: In separate notices of deficiency mailed to each petitioner on December 30, 1983, the Commissioner determined the following deficiencies in, and additions to, petitioners' Federal income tax:

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Thomas J. Rodeck

Year	Deficiency	Additions to Tax Sec. 6651(a)(1)[1]	Sec. 6653(a)(1)	Sec. 6653(a)(2)	Sec. 6654
1978	$ 4,978.00	$ 669.50	$248.90	---	$ 67.00
1979	5,583.00	1,087.50	279.15	---	168.97
1980	6,872.00	1,615.00	343.60	---	273.37
1981	10,849.00	2,553.00	542.45	*	895.12

* 50 percent of interest due on $10,849.00

Judy A. Rodeck

Year	Deficiency	Additions to Tax Sec. 6651(a)(1)	Sec. 6653(a)(1)
1978	$1,079.00	$57.25	$53.95
1979	689.00	50.50	34.45

The issues to be considered are: (1) Whether the wages received by petitioners, Thomas Rodeck and Judy Rodeck, resulted in taxable income; (2) whether petitioners are entitled to charitable contributions to a church; (3) whether, after having failed to file returns, petitioners are entitled to use the rates for taxpayers who are married and filing jointly; and (4) whether the additions to tax under sections 6651(a)(1), 6653(a)(1), 6653(a)(2) and 6654 are applicable, as appropriate, to petitioners.

Petitioners, Thomas and Judy Rodeck (hereinafter either "Thomas" or "Judy"), are husband and wife and resided in Schererville, Indiana, at the time the joint petition was filed in this case. Petitioners are college educated and filed a joint Federal income tax return for the taxable year 1977. Thomas was

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

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employed full-time as a salesman and national market specialist by Panduit Corporation and he was also employed part-time at Jay & Ernies Liquor City during the taxable years 1978 through 1981. Judy was an elementary school teacher and worked both full and part-time in local parochial and public schools during the taxable years 1978 through 1981. The parties have stipulated the amounts of wages that were received by both Thomas and Judy during the pertinent periods. Petitioners contend, however, that these wages are not subject to tax.

During the taxable years 1978 and 1979, Thomas earned interest income in the amounts of $58 and $123, respectively. During the taxable years 1978 and 1979, Judy earned interest income in the amounts of $120 and $134, respectively. Other than the issues remaining for our consideration, the parties have stipulated all other income and deduction items for the taxable years in question and the parties' stipulation of facts and stipulation of agreed issues are incorporated herein by this reference.

Petitioners' Contributions
to Hegewisch Baptist Church

On this issue, petitioners, in their petition, claimed that their deductions for the taxable years 1980 and 1981 were $714 and $920. After filing the petition, petitioners now contend that their 1981 contributions totaled $1,920, rather than $920. In support of the claimed contribution deductions, Thomas testified that he attended church approximately half the Sundays and that he

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usually makes cash contributions in twenty-dollar increments. The contributions were placed in an envelope on which the amount was marked and the envelope was submitted to the church officials. Petitioners brought forth a witness, Mr. Ireland, who assisted the treasurer of the church organization and personally tallied petitioner's annual donations. Although the amount of contributions were not tallied during the year, the contributory envelopes were sorted and maintained and the tallying was done on an annual basis wherein the amounts from the envelopes were listed on a tally sheet for the entire year. The tally sheets were received in evidence for the taxable years 1980 and 1981 and reflected the amounts of $714 and $1,920, respectively.

Respondent has contended that petitioners' church is somehow connected with tax protests and that the documentary evidence of contributions was not contemporaneously maintained by the church and, further, may have been created for the purpose of trial. The record in this case simply does not bear out respondent's contentions and, accordingly, we find that petitioners are entitled to contributions in the amounts of $714 and $1,920 for the taxable years 1980 and 1981, respectively. Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930); Clark v. Commissioner, T.C. Memo. 1970-98.

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Taxability of
Petitioners' Wages

Petitioners herein do not consider themselves to be "protesters" and argue that there is no constitutional prohibition upon the taxation of wages. Petitioners argue that their "labor [was] given [in exchange for] consideration commensurate with the market value of such labor." Petitioners admit that the Sixteenth Amendment may be constitutional and they equate their receipt of wages to a concept similar to the return of capital. In essence, petitioners believe they have basis in their labor equal to its value and that, accordingly, the amount received, since it also equals the fair market value, is not taxable. The cases and materials cited by petitioners in their brief are insufficient to vary the well-established precedent in this and other courts that wages are taxable income. Rowlee v. Commissioner, 80 T.C. 1111, 1119-1122 (1983); Reading v. Commissioner, 70 T.C. 730, 732-735 (1978), affd. 614 F.2d 159 (8th Cir. 1980). Accordingly, we hold that the amounts of wages stipulated to by the parties were taxable for the years in question. Additionally, petitioners have provided no evidence or arguments concerning why or whether the interest income to which they have stipulated should not also be taxable. Rule 142, Tax Court Rules of Practice and Procedure.

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Use of Joint Income Tax Rates

Petitioners failed to file returns for the pertinent taxable years and respondent, in separate statutory notices of deficiency, determined that petitioners were entitled to file as married individuals filing separately. The net effect of respondent's determination would require petitioners to use the rates for individuals, rather than joint rates which, in this instance, would have provided less tax overall.

It is well established that taxpayers may not "elect" rates for taxpayers filing jointly where they have failed to file returns. Thompson v. Commissioner, 78 T.C. 558 (1982); Howell v. Commissioner, T.C. Memo. 1981-631; Boyle v. Commissioner, T.C. Memo. 1975-307; contra, Tucker v. United States, 8 Cl.Ct. 575 (1985). In the instant case neither petitioner had filed a return as of the time of trial. Accordingly, a proper election has not been made to entitle either petitioner to rates for taxpayers filing jointly.

Additions to Tax

Respondent has determined additions to tax for negligence (section 6653(a)), late filing (section 6651(a)) and failure to pay estimated tax (section 6654). Petitioners simply argue it was their honest belief that amounts received in exchange for wages were not taxable. Accordingly, petitioners contend that it was reasonable for them not to file; they were not negligent in not reporting their tax and complying with the rules and regulations and there was no need to estimate tax. At the outset, we note

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that petitioners had interest income which they had not fit within their "wages are not taxable" argument. Further, there was an abundance of precedent in existence at the time that petitioners failed to file returns which clearly held that their theories for failing to file or report income were inappropriate, incorrect or otherwise not reasonable to believe. Thompson v. Commissioner, 78 T.C. 558, 563 (1982); Robinson's Dairy, Inc. v. Commissioner, 35 T.C. 601, 608-609 (1961), affd. 302 F.2d 42 (10th Cir. 1962); Lamb v. Commissioner, T.C. Memo. 1973-71. We find that petitioners' failure to file, report income, estimate tax liability and comply with the rules and regulations was neither reasonable nor justified. Accordingly, the additions to tax under sections 6651(a), 6653(a)(1), 6653(a)(2) and 6654 are applicable, in the appropriate taxable years as determined by respondent.

To reflect the foregoing,

Decision will be entered under Rule 155.

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UNITED STATES TAX COURT

FRANK LOUCIUS PERRY, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 34662-83. Filed March 17, 1986.

Elizabeth Abreu, for the respondent.

MEMORANDUM OPINION

FAY, Judge: This case is before the Court on respondent's motion to dismiss for failure of petitioner properly to prosecute and for entry of decision.

Respondent determined the following deficiencies in and additions to petitioner's Federal income tax:

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Year	Deficiency	Sec. 6653(b)[1] Addition to tax
1980	$6,105.35	$3,052.68
1981	2,995.00	1,497.50

Petitioner filed a petition with this Court in which he alleged error with respect to respondent's determination. Respondent thereafter filed an answer and, as permitted by Rule 41(a), an amended answer. In his amended answer, respondent both denied the substantive allegations of the petition and affirmatively alleged fraud on the part of petitioner for each of the years in issue.

Since petitioner did not file a reply, respondent filed a motion for entry of an order that the undenied allegations of fact set forth in the amended answer be deemed admitted pursuant to Rule 37(c). Thereafter, this Court served upon petitioner a notice of filing of motion for order under Rule 37. Petitioner was thereby notified that, if he filed a reply as directed by the Court on or before the prescribed date, respondent's motion would be denied, and that if he failed to file a reply, the Court would grant respondent's motion and deem admitted the affirmative allegations in the amended answer. Petitioner failed to file a reply as directed by the Court's notice, and the Court thereafter entered an order on June 25, 1984, pursuant to which the

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

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affirmative allegations of fact set forth in paragraphs 6(a) through 6(p) of respondent's amended answer were deemed to be admitted.

By means of a notice setting case for trial, dated February 12, 1985, the Court notified petitioner that trial of this case would be held at the Court's trial session commencing May 14, 1985 in San Francisco, California. This notice included the following paragraph:

> The calendar for that Session will be called at 10:00 a.m. on that date and both parties are expected to be present at that time and be prepared to try the case. YOUR FAILURE TO APPEAR MAY RESULT IN DISMISSAL OF THE CASE AND ENTRY OF DECISION AGAINST YOU.

On May 14, 1985, when this case was called for trial, petitioner did not appear. At that time, respondent filed a motion to dismiss this case for failure of petitioner properly to prosecute and for entry of decision.

Bearing in mind that petitioner has the burden of proof with respect to the underlying deficiencies in issue, (Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a)) we first consider respondent's motion as it relates to those deficiencies. Rules 123(b) and 149(a) provide as follows:

> For failure of a petitioner properly to prosecute or to comply with these Rules or any order of the Court or for other cause which the Court deems sufficient, the Court may dismiss a case at any time and enter a decision against the petitioner. The Court may, for similar reasons, decide against any party any issue as to which he has the burden of proof; and such decision shall be treated as a dismissal for purposes of paragraphs (c) and (d) of this Rule.

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> The unexcused absence of a party or his counsel when a case is called for trial will not be ground for delay. The case may be dismissed for failure properly to prosecute, or the trial may proceed and the case be regarded as submitted on the part of the absent party or parties.

In view of petitioner's unexcused failure to appear when this case was called for trial, we conclude that dismissal is appropriate. Accordingly, as to the underlying deficiencies, respondent's motion will be granted, and a decision with respect thereto will be entered against petitioner in accordance with the foregoing provisions of the Court's rules.

Respondent has also asked in his motion that we sustain his determination that petitioner is liable for additions to tax for each of the years in issue under section 6653(b). That section provides, in pertinent part, that: "If any part of any underpayment * * * of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment."

The existence of fraud is a question of fact to be determined from the entire record. Marcus v. Commissioner, 70 T.C. 562, 577 (1978), affd. without published opinion 621 F.2d 439 (5th Cir. 1980); Stratton v. Commissioner, 54 T.C. 255 (1970). Respondent bears the burden of proving fraud by clear and convincing evidence. Section 7454(a); Rule 142(b).

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In his amended answer in this case, respondent alleged various indicia of fraud, namely, (1) that petitioner had submitted with his federal income tax returns for the years in issue false and fraudulent documents purporting to support his claimed deductions; (2) that petitioner had engaged in a pattern of claiming on his Federal income tax returns deductions for expenses which had not been incurred and exemptions which had no basis in fact; and (3) that petitioner had submitted to respondent's agents false and fraudulent documents, and had made false and misleading statements to them, in an attempt to evade his lawful tax liability. Moreover, in paragraph 6(p) of his amended answer, respondent alleged that "a part of the underpayments of tax required to be shown on petitioner's Federal income tax returns for 1980 and 1981 are due to fraud." All of these allegations were deemed admitted by this Court's order of June 25, 1984. In Doncaster v. Commissioner, 77 T.C. 334 (1981), this Court held that respondent may satisfy his burden of proof in the issue of fraud by relying upon deemed admissions. In the instant case, the matters deemed admitted comprise allegations of specific facts evidencing fraud on the part of petitioner, as well as an allegation that a part of each of the underpayments here in issue was due to fraud. We consider these to be more than sufficient for us to conclude that respondent has satisfied his burden of proof on this issue.[2] Accordingly, we sustain the

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[2] Our conclusion is not altered by the fact that the allegation in paragraph 6(p) of respondent's answer involves an (footnote continued)

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imposition of the additions to tax under section 6653(b).

To reflect the foregoing,

An appropriate order and decision will be entered.

(footnote continued from previous page)
ultimate conclusion of fraud. In Doncaster v. Commissioner, 77 T.C. 334 (1981), we stated:

> The fact that subparagraphs (h) and (i) are worded in conclusory language does not require a different conclusion. They were "specified allegations" within the meaning of Rule 37(c); in our judgment, their deemed admission more than satisfies the respondent's burden of proof. Marcus v. Commissioner, 70 T.C. 562, 577 (1978); cf. Ritchie v. Commissioner, 72 T.C. 126, 129 (1979). We are reinforced in our conclusion by the numerous holdings that fraud is a question of fact--albeit an ultimate question of fact. E.g., Grosshandler v. Commissioner, supra at 19. Even if we were to take the view that, in the context of this case, the ultimate issue of fraud should not be considered a pure question of fact, it is at least a question of "the application of law to fact" and consequently is an appropriate matter for the Court to deem admitted. Cf. Rule 90(a), Tax Court Rules of Practice and Procedure; rule 36(a), Fed. R. Civ. P. * * * [Doncaster v. Commissioner, supra at 337. Fn. ref. omitted.]

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T. C. Memo. 1986-101

UNITED STATES TAX COURT

ROGER G. AND ELAINE M. SMITH, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 22142-83. Filed March 17, 1986.

Roger G. Smith, pro se.

Cindy E. Pilsecker, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

BUCKLEY, Special Trial Judge: This case[1] was assigned to the undersigned pursuant to the provisions of section 7456(d)(3),

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[1] This case was originally filed as a small tax case as provided for in section 7463. On February 21, 1984, petitioners moved to remove this case from the small tax category. The Court, by order dated February 27, 1984, granted petitioners' motion.

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Internal Revenue Code of 1954, and Rules 180, 181 and 182, Tax Court Rules of Practice and Procedure.[2]

Respondent determined a deficiency of $3,435 in petitioners' 1978 Federal income tax and an addition to tax of $172 for negligence under section 6653(a). The issues for decision are whether petitioners improperly deducted $20,000 as developmental expenditures pursuant to section 616(a) and whether petitioners acted negligently with regard to this deduction.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits thereto are incorporated by this reference.

Petitioner,[3] Roger G. Smith, and his wife resided in Foxboro, Massachusetts, at the time the petition was filed. Petitioner filed his 1978 Federal income tax return with respondent's service center in Andover, Massachusetts.

On his income tax return, petitioner listed his occupation as investment advisor, however, he showed no wages or commissions from any advisory activities. In reality, petitioner was an investor, and a very successful one at that. For the year in

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2 Section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. Rule references are to the Tax Court Rules of Practice and Procedure.

3 Elaine M. Smith is a party to this litigation only because the tax return in issue was filed jointly with her husband, Roger G. Smith. Only the activities of Roger Smith are at issue here, and for this reason we will refer to petitioner in the singular.

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issue, petitioner had income totaling $140,934.[4] After deductions and exclusions, however, petitioner paid only $10,652 in Federal income taxes, all of which was alternative minimum tax due on tax preference items, pursuant to section 55. Petitioner prepared his own Federal income tax return and is obviously well acquainted with the Federal tax law.

Respondent concedes that most of petitioner's tax reducing transactions were within the bounds of permissibility. Respondent has, however, disallowed a $20,000 deduction taxen by petitioner for mining development expenses pursuant to section 616(a).

Toward the end of 1978, petitioner paid $5,000 to International Monetary Exchange (herein IME), a tax shelter promoter, who was promotiong a shelter called Gold For Tax Dollars (herein GFTD). In connection with the $5,000 payment made to IME and his execution of a nonrecourse note, petitioner claimed a $20,000[5] deduction for mining development expense. If properly deductible, the $5,000 payment saved petitioner some $5,979 in Federal income taxes.

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4 Petitioner's income was composed of the following:

Interest	$ 5,048
Dividends	794
Short Term Capital Gain	11,713
Long Term Capital Gain	111,293
Section 1231 gain	12,086
Total Income	$140,934

5 IME purportedly lent $15,000 to petitioner on a nonrecourse basis. This will be discussed more fully infra.

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The GFTD plan provided that IME would obtain for petitioner a mineral lease on certain gold bearing land in southeastern Panama from Diversiones Internacionales, S.A. (herein DISA).[6] Petitioner entered into a mineral claim lease with DISA on December 29, 1978. He thereby obtained a lease on 12,500 cubic meters of auriferous gravel. IME did not charge petitioner anything for its services in obtaining the lease nor did petitioner have to pay anything for the lease itself.[7]

The lease referred to petitioner as miner. The leased premises were described as "Tuquesa Mining Properties Contract No. 35, Republic of Panama Lot #B44 12,500 cubic meters." The lease granted petitioner, as miner--

> unrestricted right to enter upon the surface of said leased premises and develop all ore producing sands and soils to exhaustion and for such purposes [miner] shall have the right to free ingress and egress to and from said Leased Premises with such persons and tools necessary for the purpose of testing for gold at any time.

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6 DISA's interest in the mineral property was purportedly acquired in January 1978 when it entered into a lease with Tuquesa Mining, S.A. (herein TMSA). DISA was granted the right to extract all the gold from properties known as the Tuquesa Mining Properties. TMSA acquired its interest in the Tuquesa Mining Properties when the Panamanian Mining Bureau purportedly granted TMSA Exploration Concesion Contract #35.

7 The mineral lease included the following provision: "For One Dollar and other valuable considerations, Lessor hereby demises [the mineral property]." The promotional literature, however, makes no reference to any such payment, nor does petitioner suggest that he paid any money for the lease.

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Petitioner was not required to mine any gold during the term of the lease, which ran until either petitioner removed for processing the 12,500 cubic meters of soil which was the subject of the lease or DISA's mineral concession expired. DISA retained the right to terminate the lease if petitioner discontinued or abandoned operation of the mining process, but only after notifying petitioner in writing. The lease required petitioner to pay DISA "50% of the recovered gold 'at site' after first deducting all development costs and any mineral tax due [Panama]."

Another aspect of the GFTD plan was the so-called loan between IME and petitioner. On December 28, 1978, IME and petitioner, again listed as miner, executed a mineral loan agreement for $15,000 which was to be paid on petitioner's behalf "to an approved contractor for development costs" related to petitioner's mineral interest. The money was lent to petitioner on a nonrecourse basis, which meant that petitioner was not personally liable for its repayment. As its sole security, IME took a "general lien" on petitioner's mineral interest. The only source of repayment of the loan would be the proceeds of the mining operation. The loan bore interest at 10 percent per annum payable annually. Any unpaid interest when due, however, was to be treated as a new advance under the loan agreement. Petitioner never received any proceeds from this so-called loan, as they were purportedly paid to a mining contractor on petitioner's behalf.

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Petitioner claims to have entered into this transaction with the intention of making a profit.

Petitioner claimed as development expense the $5,000 he paid to IME, as well as the $15,000 IME purportedly lent him.

Before petitioner invested in the GFTD program, IME supplied him with a promotional brochure entitled Tuquesa Mining Properties (herein the brochure). The brochure purports to describe the location of the alleged mining property and some alleged exploratory work. The brochure also contains some maps and photographs of the purported mineral properties. Copies of an alleged assay report and an alleged statement of a sale of gold, as well as some general information on world gold productions, are also included in the promotional brochure. The assay report and statement of gold sale both were dated June 1975, and were not related to petitioner's specific mineral property.

IME also supplied petitioner, prior to his investment, with a tax opinion letter prepared for a Mr. James Mongello by the law firm of Kallen, Grant, May & Tremblatt. The opinion letter discusses the Federal tax implications of an investment in the GFTD plan, which is very similar to that involved here. The import of the opinion letter is that an investment in GFTD is legitimate and would withstand challenge by respondent.

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OPINION

The issue of whether petitioner improperly deducted $20,000 as developmental expense can be separated into two very distinct analyses.

Regardless of how we decide the applicability of section 616 with respect to the facts presented here, the portion of the $20,000 deduction represented by the $15,000 nonrecourse loan by IME will not be permitted. That portion of the deduction is controlled by Saviano v. Commissioner, 765 F.2d 643 (7th Cir. 1985), affg. 80 T.C. 955 (1983). At trial and in a motion dated June 18, 1984, petitioner agreed to be controlled by the outcome of the Court of Appeals' decision in the Saviano case, which was pending at the time.

Except for some minor dissimilarities,[8] the facts of Saviano v. Commissioner, supra, are virtually identical to those presented here. Saviano involved the GFTD program at issue here, including an identical mineral loan agreement. In that case, only the nonrecourse loan portion of the plan was before the court. This is because the Tax Court, for summary judgment purposes, assumed that the transactions occurred as described in the promotional literature. Saviano v. Commissioner, 80 T.C. at 961 and 765 F.2d at 645. The Court of Appeals, affirming the Tax

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The Saviano case was before this Court on motions for partial summary judgment. Obviously, that case involved a different taxpayer. The 1979 tax year was involved, as well as 1978. The total deduction in that case was $40,000, with $10,000 being the taxpayer's cash payment to IME.

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Court, held that the essence of the relationship between IME and the taxpayer was that of joint investors and that no true loan existed between them. Saviano v. Commissioner, 765 F.2d at 646-650. There is no reason at this time to hold otherwise, and respondent's determination respecting the $15,000 nonrecourse loan portion of petitioner's $20,000 deduction will be sustained.

Since only the nonrecourse loan portion of a GFTD related deduction was before the Court in Saviano v. Commissioner, supra, the deductibility of the $5,000 petitioner paid to IME cannot be decided with such easy reference to a single case.

Petitioner claimed this deduction as a development expense under section 616(a) which provides, in part:

> Except [in the case of an election by the taxpayer under subsection (b)], there shall be allowed as a deduction in computing taxable income all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed.

Section 616 is not applicable to development expenditures which are deductible under other provisions of the Code, section 1.616-1(b)(1), Income Tax Regs., nor is it applicable to expenditures which are reflected in improvements subject to depreciation. Sec. 1.616-1(b)(2), Income Tax Regs.

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Expenditures for development deducted pursuant to section 616 must be incurred on property in which petitioner has previously acquired some proprietary interest. Anderson v. Commissioner, 83 T.C. 898, 908 (1984), on appeal (9th Cir., Mar. 5, 1985). Expenses for acquiring the required proprietary interest or for acquiring a right of access to the property are not deductible. Anderson v. Commissioner, supra; Geoghegan & Mathis, Inc. v. Commissioner, 55 T.C. 672, 675-676 (1971), affd. 453 F. 2d 1324 (6th Cir. 1972), cert. denied 409 U.S. 842 (1972).

In order to qualify for deductibility under section 616, the expenditures must be for development and the mine must have reached the development stage. Estate of DeBie v. Commissioner, 56 T.C. 876, 890 (1971).

It must be kept in mind that deductions from income are matters of legislative grace, and petitioner is, therefore, required to show that he comes within the terms of the statute under which he is claiming the deduction. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934). There is a presumption of correctness attached to respondent's deficiency determination and petitioner has the burden of showing it is erroneous. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). Petitioner can only satisfy this burden by "adequate presentation of the pertinent facts" and cannot rest on assumption or speculation. Wood Corp. of Delaware v. Commissioner, 22 B.T.A. 1182, 1186 (1931), affd. 63 F.2d 1023 (6th Cir. 1933).

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From the aforementioned authorities, it is clear that in order to prevail, petitioner must prove that he had some proprietary interest in gold producing land and that he paid or incurred expenditures for mineral development with respect to that land. Petitioner must also show, however, that the mineral property has reached the development or production stage and that the expenditures were paid or incurred "after such time when, in consideration of all the facts and circumstances * * * deposits of [gold] are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation * * *." Sec. 1.616-1(a), Income Tax Regs.

Petitioner has failed completely to prove that which need be proven. The only thing which can be determined with certainty is that petitioner paid $5,000 to IME. With respect to the other elements, however, petitioner has not met his burden. The record is devoid of positive proof that the money paid to IME was actually expended for development of gold producing property in which petitioner had the requisite proprietary interest.[9] Although petitioner paid $5,000 to IME, there is nothing to indicate that the money was spent on development. It is true that the mineral loan agreement refers to petitioner's cash outlay as "miners development capital," but this alone is not sufficient to sustain the proposition that the $5,000 was

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9 We will assume that the mineral lease executed by petitioner and IME was valid and did grant petitioner the right to mine a specific piece of realty.

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actually spent on development. In fact, such a proposition is really a soap bubble ready to burst when put in contact with the facts. Such a conclusion would require and petitioner would have us believe that IME, who was promoting GFTD, received no consideration for its promotional activities. Certainly, some of this $5,000 went to IME for promotion. Assuming that GFTD was a legitimate investment, we find it hard to believe that IME would promote such a plan without consideration.[10]

Petitioner still would not prevail, had he shown to our satisfaction that the $5,000 was expended for development, because he failed to prove that the mine had reached the development stage and that he expended the $5,000 after a commercially marketable quantity of gold had been disclosed. Sec. 616(a). Only in the promotional brochure supplied by IME entitled "Tuquesa Mining Properties" is there any reference with respect to these propositions. The problem is that the promotional brochure is a hearsay document and cannot be used as proof of matters asserted within it. This Court follows the rules of evidence in the Federal Rules of Civil Procedure. Rule 143(a). The Federal Rules of Evidence provide for the inadmissibility of hearsay. Fed. R. Evid. 802. Hearsay is

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One could argue that IME's consideration was in finding a captive market for its loans. But this does not comport with common sense and good business judgment. The loans carried a 10-percent annum interest rate at a time when the prime interest rate (a fact of which we take judicial notice), the rate commercial banks charge their most credit worthy customer, was well in excess of 11 percent and on the rise. See Thorndike Encyclopedia of Banking and Financial Tables (1984).

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defined as an out of court statement "offered in evidence to prove the truth of the matter asserted." Fed. R. Evid. 801(c). The statements contained in the promotional brochure certainly come within this definition of hearsay and are inadmissible to show their truth. Since the brochure does not come within any of the recognized exceptions to the hearsay rule, its use must be restricted to showing why petitioner may have participated in the GFTD program. It was for this reason, and this reason only, that the document was received into evidence.

Because petitioner has failed to prove that which is required to be proven under section 616(a) he will not be allowed to deduct the $5,000 paid to IME. One may question what sort of proof may have been adequate to satisfy petitioner's burden, however, impossibility of proof is the problem of the party on whom the burden of proof rest. See, e.g., Burnet v. Housten, 283 U.S. 223 (1931).

Further, we must reject petitioner's claim that he entered into this transaction with the intent of making a profit. The only profit that petitioner appeared to be looking toward was that relating to the decrease in his tax liability from a $20,000 deduction as a result of a $5,000 cash payment. It is well established that transactions entered into primarily for tax benefits are not profit motivated. See Knetsch v. United States, 172 Ct. Cl. 378, 348 F.2d 932 (1965), cert. denied 383 U.S. 957

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(1966); Fox v. Commissioner, 82 T.C. 1001 (1984). See also Thomas v. Commissioner, 84 T.C. 1244 (1985), on appeal (4th Cir., Sept. 13, 1985).

We now move to determining whether petitioner was negligent with respect to claiming this $20,000 deduction. Respondent determined a $172 addition to tax, pursuant to section 6653(a), which provides for a 5-percent (of deficiency) addition if "any part of any underpayment * * * of any tax * * * is due to negligence or intentional disregard of rules and regulations." Petitioner bears the burden of proving respondent's determination erroneous. Rule 142(a); Enoch v. Commissioner, 57 T.C. 781 (1972).

Petitioner in this case was a very successful investor. He was obviously well acquainted with Federal income tax law. He prepared his own tax return for 1978, which was very complicated, and did a proficient job. Petitioner claims he believed he was entering into a legitimate transaction when he involved himself in Gold For Tax Dollars. He makes reference to the tax opinion letter which was accepted into evidence. This opinion letter, however, was supplied by IME and, of course, stated that GFTD involvement would withstand Internal Revenue Service scrutiny. He did not independently consult anyone with respect to the propriety of the deduction taken. Given his sophistication with the tax law, we cannot say that his reliance on (if he did so rely) the tax opinion letter supplied to him by the promoter of the tax shelter was sufficient to rebut the presumption operating

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against him. See, e.g., Mustain v. Commissioner, T.C. Memo. 1982-670. Respondent will be sustained with respect to the negligence addition.

Decision will be entered for the respondent.

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T. C. Memo. 1986-102

UNITED STATES TAX COURT

LEO W. SCOTT and MAXINE B. SCOTT, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 33916-83. Filed March 17, 1986.

Held, Ps' failure to report gross receipts from their sole proprietorship over a 4-year period was due to fraud within the meaning of sec. 6653(b), I.R.C. 1954.

Harrison T. Slaughter, Jr., for the petitioners.

Francis C. Mucciolo, for the respondent.

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MEMORANDUM OF FINDINGS OF FACT AND OPINION

SIMPSON, Judge: The Commissioner and the petitioners agreed on the amount of the deficiency in income tax for each of the years 1974 through 1977, prior to the issuance of the notice of deficiency in this case. In addition, the Commissioner determined the following additions to the petitioners' Federal income taxes:

Year	Addition to Tax Sec. 6653(b) I.R.C. 1954[1]
1974	$ 9,139.31
1975	1,931.10
1976	5,261.83
1977	10,071.60

The only issue for decision is whether the petitioners' failure to report gross receipts from their trucking business in the taxable years 1974 through 1977 was due to fraud within the meaning of section 6653(b).

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1 All statutory references are to the Internal Revenue Code of 1954 as in effect during the years in issue.

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FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.[2]

The petitioners, Leo W. and Maxine B. Scott, husband and wife, maintained their legal residence in Ozona, Florida, when they filed their petition in this case. They filed joint Federal income tax returns for 1974 through 1977 with the Internal Revenue Service Center, Atlanta, Georgia.

During the years at issue, the petitioners owned and operated a sole proprietorship known as Barlow and Scott Trucking, or Scott Trucking. Prior to 1968, the petitioners owned and operated the business with Mrs. Scott's father. The main activities of the business included hauling landfill materials and renting earth moving equipment.

In January 1974, Mrs. Scott, a high school graduate, retired from her job as a bank teller after 27 years at the Sun First National Bank of Dunedin. At the bank, she was responsible for cashing checks, taking deposits, balancing her daily cash, preparing State sales tax reports, and handling similar matters.

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[2] The petitioners in their reply brief failed to set forth any objections to the Commissioner's requested findings of fact. Because of the failure to comply with Rule 151(e)(3), Tax Court Rules of Practice and Procedure, the Commissioner requests that we adopt his requested findings that were not contradicted by the petitioners. We decline to do so, but rather base our findings of fact upon the evidence and testimony of record.

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During the years in issue, Mrs. Scott performed various office tasks at Scott Trucking, including: answering the phone, running errands, writing checks, typing most of the billing invoices, and occasionally depositing money in the Scott Trucking checking account. Mrs. Scott also prepared the State sales tax reports using information provided by her husband. At a minimum, she prepared invoices in the amounts of: $66,797.87 in 1974, $78,928.49 in 1975, $131,891.34 in 1976, and $213,787.24 in 1977.

Mr. Scott, a high school graduate and former insurance agent, was responsible for the operation of Scott Trucking. Among other responsibilities, he kept track of overdue customer accounts by writing the information on a loose piece of paper. He sometimes cashed checks received as payment and used the cash to pay business expenses. The receipts from these cash transactions were used, along with check stubs, to document Scott Trucking expenses. Other checks were deposited by either of the petitioners. Checks arising from transactions subject to the State sales tax were deposited in the Scott Trucking checking account; others were deposited in the petitioners' personal checking account. Both accounts were at Sun First National Bank of Dunedin.

The petitioners employed the same tax return preparer (tax preparer) during all the years at issue. On a quarterly basis, Mr. Scott provided him with the records

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from which he prepared the petitioners' income tax returns. Expense information consisted of cancelled checks, receipts for cash expenditures, and similar documentation contained in a box. The revenue information provided by Mr. Scott consisted of quarterly totals from the monthly State sales tax reports. The reported revenue included only receipts from materials sold, not receipts from services provided. As a consequence, in 1974, the petitioners reported receipts of $7,329.50 for Scott Trucking, when the proper figure was $96,838.05; and in 1975, the reported receipts were $5,044.50, while the actual figure was $80,636.65.

In 1976, the expense information provided to the tax preparer by Mr. Scott exceeded the $7,306.50 in receipts reported on the State sales tax reports. When the tax preparer pointed out to Mr. Scott that the expenses exceeded the receipts, Mr. Scott produced a Form 1099 from Scarborough Construction Company (Scarborough), which raised reported receipts to $74,465.33. This was the first time a Form 1099 from Scarborough was provided to the tax preparer, even though Scott Trucking received substantial income from Scarborough in both 1974 and 1975. No evidence was presented indicating that the petitioners had provided the tax preparer with any information concerning Scarborough for 1974 or 1975. In 1977, total reported receipts were $89,561.24, with $37,301.81 coming from the State sales tax reports and the remainder from Scarborough. The actual

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receipts of Scott Trucking were $131,891.34 in 1976 and $213,787.24 in 1977.

In 1974, the petitioners sold a parcel of real estate for $33,000.00. They had purchased the parcel in 1972 for $12,500.00. Although they had a gain of $18,288.70 after selling expenses, the item did not appear on their tax return.

The petitioners reported some of their interest income for each year, but they failed to report interest income in the amounts of $82.34 for 1974, $277.00 for 1975, $372.00 for 1976, and $1.71 for 1977.

Finally, both petitioners voluntarily signed all the returns, and there was no evidence that they did not have an adequate opportunity to review the returns prior to signing. Their signed returns understated taxable income by $53,231.76 for 1974, $20,040.88 for 1975, $38,861.75 for 1976, and $52,605.27 for 1977.

OPINION

The only issue for decision is whether any part of the underpayment of tax for each of the taxable years 1974 through 1977 was due to fraud within the meaning of section 6653(b). Such section provides that if any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment. The Commissioner has the

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burden of proving, by clear and convincing evidence, that some part of the underpayment for each year was due to fraud. Sec. 7454(a); Rule 142(b), Tax Court Rules of Practice and Procedure; Levinson v. United States, 496 F.2d 651, 654-655 (3d Cir. 1974); Otsuki v. Commissioner. 53 T.C. 96, 105 (1969). To establish fraud, the Commissioner must show that the taxpayer intended to evade taxes which he knew or believed that he owed, by conduct intended to conceal, mislead, or otherwise prevent the collection of such taxes. Webb v. Commissioner, 394 F.2d 366, 377-378 (5th Cir. 1968), affg. a Memorandum Opinion of this Court; Powell v. Granquist, 252 F.2d 56, 60 (9th Cir. 1958); Acker v. Commissioner, 26 T.C. 107, 111-112 (1956).

The presence or absence of fraud is a factual question to be determined by an examination of the entire record. Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978). Fraud will never be presumed. Beaver v. Commissioner, 55 T.C. 85, 92 (1970). However, fraud may be proved by circumstantial evidence since direct proof of the taxpayer's intent is rarely available. The taxpayer's entire course of conduct can often be relied on to establish the requisite fraudulent intent. Stone v. Commissioner, 56 T.C. 213, 223-224 (1971); Otsuki v. Commissioner, supra at 105-106.

The evidence convincingly establishes that the petitioners fraudulently underpaid their taxes during each

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of the years at issue. They furnished the information for their tax returns, and those returns understated taxable income by $53,231.76 for 1974, $20,040.88 for 1975, $38,861.75 for 1976, and $52,605.27 for 1977. Such a consistent pattern of underreporting substantial amounts of income, over a period of several years, standing alone, is highly persuasive evidence of fraud. Adler v. Commissioner, 422 F.2d 63, 66 (6th Cir. 1970), affg. a Memorandum Opinion of this Court; Merritt v. Commissioner, 301 F.2d 484, 487 (5th Cir. 1962), affg. a Memorandum Opinion of this Court; Davis v. Commissioner, 239 F.2d 187, 191 (7th Cir. 1956), affg. a Memorandum Opinion of this Court; Marcus v. Commissioner, 70 T.C. 562, 577 (1978), affd. without published opinion 621 F.2d 439 (5th Cir. 1980)

The petitioners were under a duty to keep adequate books and records. Sec. 6001; sec. 1.6001-1, Income Tax Regs. The petitioners' failure to do so is some evidence of fraud. Harper v. Commissioner, 54 T.C. 1121, 1141 (1970); Otsuki v. Commissioner, 53 T.C. at 110. The petitioners kept no formal ledgers; rather, they relied on a box full of receipts to document expenses and had no system for documenting total receipts. For 1974 and 1975, they reported only those receipts which were reported on their State sales tax reports, but not all of their receipts were subject to the State sales tax. When the tax preparer questioned the information furnished by Mr. Scott, he

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produced the Form 1099 from Scarborough reflecting the receipt of substantial additional income. It is significant that the petitioners arranged to furnish records of their expenses to their tax preparer, but they neglected to inform him of the receipt of a large amount of income for each year.

The petitioners' contention that they relied upon their tax preparer to keep the required records is not well founded. First, the evidence showed that he was hired as a tax preparer, not as an accountant or bookkeeper hired to maintain financial records; he simply relied upon the information furnished by Mr. Scott to prepare the tax returns. Additionally, it is apparent that the petitioners withheld information from the tax preparer, so that, regardless of his role, he could not produce an accurate return. For example, he was supplied with the bank statements from the Scott Trucking checking account, but he was not given the petitioners' personal checking account statements, which contained business deposits arising from transactions not subject to State sales tax.

The petitioners' failure to report their interest income during the years in question is evidence of fraud. Although the amounts involved were small, the petitioners' consistent and unexplained practice of reporting only a portion of their interest income is indicative of fraud, as it clearly shows they were aware of their legal obligation

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to report interest income, yet chose not to fulfill their duty.

The petitioners' failure to report the $18,288.70 gain arising from the sale of a parcel of real estate in 1974 is further evidence of fraud. This was a large sum of money arising out of a memorable transaction which the petitioners should have noticed was missing from their return.

The petitioners seek to avoid a finding of fraud by claiming that they did not understand business affairs and that they were not aware of the underreporting. The petitioners argue that any fault lies with the tax preparer because he was incompetent. Alternatively, if fraud is found, they argue that Mrs. Scott should be relieved of liability under section 6653(b)(4) because she did not participate in activities related to Scott Trucking.

In support of the argument that their conduct was not fraudulent, the petitioners rely on Revader v. Commissioner, T. C. Memo. 1980-473. In that case, this Court carefully reviewed the entire record in making the determination that the Commissioner had not proven fraud; no one fact was controlling. The case at hand is clearly distinguishable. First, the petitioners have not shown that their tax preparer was incompetent; indeed, they declined to cross-examine him. Second, the underreporting in this case took place over 4 years; whereas in Revader, only 2 years were in

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question. Finally, in contrast to Revader, we are convinced that the petitioners in this case knew that they were underreporting their income. Each year, Mrs. Scott, a woman with considerable bookkeeping experience, prepared invoices with a total value significantly in excess of the income reported on each return. Mr. Scott directed his wife in this activity and handled the collection and deposit of receipts greatly in excess of the amount of income reported. The discrepancy between the actual and reported income of the petitioners is simply too great to believe that the petitioners were the innocent victims of their tax preparer. Additionally, the ease with which Mr. Scott produced the Form 1099 from Scarborough when the tax preparer pointed out that his expenses exceeded his receipts, after years of not providing that information, indicates that he had a real understanding of what information he should have been reporting. It may be that the tax preparer should have raised more questions about the information furnished him; even so, we are convinced that the petitioners were aware that their actual income grossly exceeded their reported income for the years at issue and that the underreporting cannot be attributed to a lack of understanding of business affairs.

Although Mrs. Scott is liable for the deficiencies in income tax under section 6013 because she filed joint returns, she is liable for additions for fraud only if the

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Commissioner has shown that some part of the underpayment is due to fraud on her part. Sec. 6653(b)(4); Stone v. Commissioner, 56 T.C. at 226-228. In light of her 27 years as a teller, her education, and her activities in support of Scott Trucking, we conclude that the Commissioner has shown fraud on the part of Mrs. Scott.

A final observation concerning the evidence in this case is appropriate. The petitioners' testimony was at times inconsistent with, and even contradicted, their answers to the Commissioner's written interrogatories. In addition, in their testimony, they displayed an unbelievable inability to recall facts related to their fraud. For example, Mrs. Scott testified that her husband reconciled all the checking accounts; the petitioners' answer to the interrogatories was in agreement. However, Mr. Scott testified that he never reconciled any checking account, because he did not know how to reconcile a checking account. Mrs. Scott testified that she did nothing with reference to running the business, but rather took care of household chores. Yet, in the answers to interrogatories, the petitioners stated that she carried out numerous clerical functions for Scott Trucking. Indeed, the parties stipulated that all the billing invoices used to estimate the stipulated total receipts of Scott Trucking were typed by Mrs. Scott. The convenient inability of the petitioners to recall significant facts was illustrated by Mrs. Scott

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when she was asked if she recollected the gain from the sale of real estate in 1974, and responded "I couldn't tell you what I bought at the grocery store yesterday." Such conduct seriously undermined the credibility of the petitioners in the view of this Court, particularly with respect to denials concerning Mrs. Scott's knowledge of Scott Trucking operations.

Decision will be entered for the respondent.

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T. C. Memo. 1986-103

UNITED STATES TAX COURT

THOMAS B. BLAKE, JR. AND SUE H. BLAKE, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

JOYCE M. BLAKE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 24872-83, 28725-83. Filed March 17,1986.

Held: Installment payments under separation agreement found to be due within 10 years for purposes of section 71(c)(2) as then in effect.

Richard A. Childs, counsel for the petitioners in Docket No. 24872-83.

Morton A. Harris, counsel for the petitioner in Docket No. 28725-83.

Roslyn G. Taylor, for the respondent.

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MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: In these consolidated cases respondent determined deficiencies against petitioners Thomas B. Blake (Dr. Blake) and wife Sue H. Blake[1] for the years 1979 and 1980 in the amounts of $5,291.78 and $5,237.50, respectively, and against petitioner Joyce M. Blake (Mrs. Blake) for the same 2 years in the amounts of $2,456 and $3,007, respectively. The issue in each case is whether certain payments made by Dr. Blake to Mrs. Blake, his former wife, pursuant to a property settlement incorporated into a divorce decree are taxable to Mrs. Blake under section 71[2] and thus deductible by Dr. Blake under section 215. For convenience, our Findings of Fact and Opinion are combined.

Some of the facts have been stipulated and are so found. At the time the petition was filed in Docket No. 24872-83, the petitioners in that case were residents of Phenix City, Alabama. At the time the petition was filed in Docket No. 28725-83, Mrs. Blake was a resident of Columbus, Georgia.

Dr. Blake and Mrs. Blake were married in 1951. Four children were born of the marriage. By decree dated May 30, 1975, the Circuit Court of Russell County, Alabama, dissolved the marriage of these parties, incorporating in the decree by

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1 Dr. Blake's present wife Sue H. Blake, is a party only by reason of having filed joint income tax returns with her husband and having joined in this petition.

2 All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

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reference the property settlement agreement of the same date. Custody of the four children was awarded to Mrs. Blake, provision made for their support, certain assets allocated to Mrs. Blake and provision made for annual payments for a term certain in the following language:

> 12. It is further agreed between the Plaintiff and Defendant that the Plaintiff, Thomas B. Blake, Jr. shall pay to the Defendant and Cross-plaintiff, Joyce McCartha Blake, the sum of One Thousand and no/100--- Dollars ($1,000.00) each month for a period of ten years or 120 months; and said payment shall begin thirty (30) days after the date of the granting of any decree in this case; and the payment of this amount is the payment of alimony in gross and is in lieu of permanent alimony to be paid to the Defendant.
>
> The parties agree that said Paragraphs Two (2), Three (3), Five (5), Six (6), Ten (10), Eleven (11), and Twelve (12) of this agreement constitute a complete property settlement between the parties.

The issue here is the tax consequence of the $1,000 per month payments during the years 1979 and 1980. Respondent is essentially a disinterested stakeholder, having issued inconsistent statutory notices to the two taxpayers but recognizing that tax treatment should be consistent.

None of the parties seriously contends that the payments during each of these 2 years of $12,000 per year by Dr. Blake to Mrs. Blake constitute conventional alimony, although Dr. Blake argues that the $1,000 per month in practical effect did support Mrs. Blake. The narrow issue is whether under section 71(c)(2),

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as then in effect[3], these payments are required "to be paid or may be paid over a period ending more than 10 years from the date of" the decree. Although not decisive in this case the monthly $1,000 payments were not intended by the parties to be conventional alimony. The intent of Mrs. Blake and her advisors was that this sum was not to be taxable to her. Dr. Blake apparently did not focus on the tax consequences at the time of the divorce.

The phrase "alimony in gross" does not have a well-defined meaning in Alabama, the applicable jurisdiction for interpretation of these documents. Under Alabama cases, an "award of alimony in gross" has aspects of a property settlement as well as of an allowance of support. Dr. Blake argues that the payments did in fact support Mrs. Blake, but he also recognizes that the 120 monthly payments would continue irrespective of the remarriage of Mrs. Blake or his death. Thus, while Dr. Blake may have thought that payments to his former wife were "alimony," hence deductible under section 215, he did not misunderstand the basic import of the arrangement. And his misapprehension of its

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3 Sec. 71. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

* * *

(c) Principal Sum Paid in Installments.--

* * *

(2) Where Period for Payment Is More Than 10 Years.-- If, by the terms of the decree, instrument, or agreement, the principal sum referred to in paragraph (1) is to be paid or may be paid over a period ending more than 10 years from the date of such decree, instrument, or agreement, * * *.

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tax consequences is immaterial, if in fact (notwithstanding his testimony) he did give any serious thought to tax considerations at the time, which we doubt.

The payments prescribed by paragraph 12 of the support agreement are installment payments for purposes of section 71(c)(1). We must determine whether the principal sum "is to be paid or may be paid over a period ending more than 10 years from the date" for purposes of section 71(c)(2). The critical date, the expiration of the 10-year period from the date of the decree, is May 30, 1985.

Dr. Blake argues first, focusing on the "period of ten years" in the support agreement and Mrs. Blake's, interpretation of the agreement as reflected in her cross-examination, that the payment period extends 28 days past the 10-year period. This argument simply ignores the "or 120 months" language of the agreement. We doubt that Mrs. Blake understood the apparent trap into which she was being led, but comments by her on the witness stand have no bearing on the issue. With more substance, Dr. Blake argues that the last payment could have been made on May 31, 1985, which day is, Blake argues, 10 years and two[4] days after May 30, 1975, the date of the decree. The premise for this argument is that under the agreement and the decree, each monthly payment is timely if made on or before the last day of the applicable month.

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[4] It is Dr. Blake's position that the 10-year period expired on May 29, 1985.

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Dr. Blake computes the 10-year period to expire on May 29, 1985. However, counsel for Dr. Blake ignores the normal rule for counting time, which is that counting commences with the day after the critical date, in this case May 31, 1975. See Sheets v. Selden's Lessee, 69 U.S. 177, 190 (1864); Hooper v. Commissioner, 26 B.T.A. 758 (1932); Tow v. Commissioner, 36 T.C. 861 (1961); Rev. Rul. 66-7, 1966-1 C.B. 188. If we exclude the designated date--the date of both the decree and the agreement--the 10-year period ends on May 30, 1985, since under this rule, we also count the last day. Similarly under the agreement the first payment was required to be made on or before June 29, 1975. One hundred twenty monthly payments later would make the final payment on or prior to May 29, 1985, or one day less than 10 years. On this basis the periodic payments are treated by section 71(c)(1) as installment payments of a sum certain. This comports with the intent of the parties.

Dr. Blake relies upon two decisions, United States v. Reis, 214 F.2d 327 (10th Cir. 1954) and Tracy v. Commissioner, 70 T.C. 397 (1978). In Reis, the Court of Appeals construed Kansas law to permit payments to be made by the end of each month. As applied here, that would be by May 31, 1985. Similarly in Tracy, we followed Mississippi law which permitted payments to be made within 30 days after the specified date, which too would be beyond the 10-year period. However, our attention has not been directed to any Alabama authority which, as applied to these facts, would permit payment to be made without default on a date

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later than the twenty-ninth day of each month. We construe the agreement to mean that the first payment was to be made on or before a date which was 30 days from the decree or June 29, 1975. Each succeeding monthly payment was to be made on or before the twenty-ninth day of each succeeding month thereafter for 120 months. The last payment thus was due on May 29, 1985. In reaching this interpretation, we give weight to the intention of the parties, as reflected in the testimony and in the agreement itself. The use of the terminology "10 years or 120 months" obviously is derived from the 10-year period set forth in section 71(c)(2) and reflects the tax treatment desired and intended by Mrs. Blake. Dr. Blake's contention that payments would be timely if made on or before the last day of each month, rather than on or before the twenty-ninth day of each month, is by necessary implication contrary to the parties' intention since such interpretation would make the installment payments taxable to Mrs. Blake.

Accordingly, we hold for petitioner Joyce M. Blake and against petitioners Thomas B. Blake, Jr. and Sue H. Blake.

In Docket No. 24872-83 decision will be entered for respondent.

In Docket No. 28725-83 decision will be entered for petitioner.

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